Supreme Court, U.S.
FILED

97 1418 FEB 23 1998

OFFICE OF THE CLERK

No. _____

In the Supreme Court of the United States

OCTOBER TERM, 1997

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION,
Successor by merger to Bank of America Illinois,
Petitioner,

v.

203 NORTH LASALLE STREET PARTNERSHIP,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

PETITION FOR A WRIT OF CERTIORARI

THOMAS S. KIRIAKOS
JAMES C. SCHROEDER
BEVERLEY J. KLEIN
Mayer Brown & Platt
190 South LaSalle St.
Chicago, Illinois 60603
(312) 782-0600

ROY T. ENGLERT, JR.
Counsel of Record
Mayer Brown & Platt
2000 Pennsylvania Ave., N.W.
Washington, D.C. 20006
(202) 463-2000

Counsel for Petitioner

QUESTION PRESENTED

The absolute priority rule, codified at 11 U.S.C. § 1129(b)(2)(B)(ii), provides that a plan of reorganization under Chapter 11 of the Bankruptcy Code may not be confirmed unless either all dissenting classes of unsecured creditors are paid in full, or no holder of a more junior claim or interest "receive[s] or retain[s] under the plan on account of such junior claim or interest any property."

The question presented in this case is the same one this Court granted certiorari to consider, but did not resolve, in *U.S. Bancorp Mortgage Co.* v. *Bonner Mall Partnership*, 513 U.S. 18 (1994):

Whether the Bankruptcy Code authorizes a judge to confirm a Chapter 11 plan of reorganization that grants the pre-bankruptcy equity owners of a debtor an exclusive opportunity to retain or purchase an ownership interest in the reorganized debtor, but does not provide for full payment to a senior, objecting class of unsecured creditors.

RULE 14.1(b) AND 29.6 STATEMENT

The parties in the court of appeals were Petitioner Bank of America Illinois, now known, as a result of a merger, as Bank of America National Trust and Savings Association, and Respondent 203 North LaSalle Street Partnership, an Illinois limited partnership.

Petitioner Bank of America National Trust and Savings Association is a wholly owned subsidiary of BankAmerica Corporation, which is a publicly held company. Bank of America National Trust and Savings Association has no nonwholly owned subsidiaries.

TABLE OF CONTENTS

Page

QUESTION PRESENTED i

RULE 14.1(b) AND 29.6 STATEMENT ii

OPINIONS BELOW 1

JURISDICTION 1

STATUTE INVOLVED 1

STATEMENT 2

A. The Absolute Priority Rule 2

B. Factual Background 3

C. Proceedings In The Court Of Appeals 5

REASONS FOR GRANTING THE WRIT 7

I. COURTS AND COMMENTATORS ARE SHARPLY DIVIDED ON THE VALIDITY OF A NEW VALUE EXCEPTION TO THE ABSOLUTE PRIORITY RULE 9

II. WHETHER THERE IS A NEW VALUE EXCEPTION TO THE ABSOLUTE PRIORITY RULE IS AN IMPORTANT AND RECURRING ISSUE 15

III. THE PANEL MAJORITY'S DECISION IS FUNDAMENTALLY FLAWED 18

A. The Plain Statutory Language Does Not Include A New Value Exception 19

B. Congress Did Not Adopt The New Value Exception *Sub Silentio* When It Enacted The Bankruptcy Code In 1978 24

C. A New Value Exception Would Be Inconsistent With The Policies Underlying The Bankruptcy Code 27

CONCLUSION 30

TABLE OF AUTHORITIES

Cases **Page**

A.V.B.I., Inc., In re, 143 B.R. 738 (Bankr. C.D. Cal. 1992) 29

Bates v. *United States*, 118 S. Ct. 285 (1997) 20

Bonner Mall Partnership, In re, 2 F.3d 899 (9th Cir. 1993) 11, 12, 13, 14, 17

Bryson Properties, In re, 961 F.2d 496 (4th Cir. 1992) 7, 10, 11, 13, 22

Caminetti v. *United States*, 242 U.S. 470 (1917) 19

Case v. *Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939) . . . . . *passim*

CFTC v. *Weintraub*, 471 U.S. 343 (1985) 28

Coltex Loop Central Three Partners, L.P., In re, No. 96-5140 (2d Cir. Feb. 19, 1998) . . . . . *passim*

Connecticut Nat'l Bank v. *Germain*, 503 U.S. 249 (1992) 19

Dewsnup v. *Timm*, 502 U.S. 410 (1992) 21

Greystone III Joint Venture, In re, 995 F.2d 1274 (5th Cir. 1991) 13, 17, 22, 27, 28

Homestead Partners, Ltd., In re, 197 B.R. 706 (Bankr. N.D. Ga. 1996) 22

Kham & Nate's Shoes No. 2, Inc. v. *First Bank*, 908 F.2d 1351 (7th Cir. 1990) . . . . . *passim*

Norwest Bank Worthington v. *Ahlers*, 485 U.S. 197 (1988) . . . . . *passim*

Patterson v. *Shumate*, 504 U.S. 753 (1992) 23

Pennsylvania Dep't of Public Welfare v. *Davenport*, 495 U.S. 552 (1990) 21

U.S. Bancorp Mortgage Co. v. *Bonner Mall Partnership*, 513 U.S. 18 (1994) . . . . . *passim*

U.S. Truck Co., In re, 800 F.2d 581 (6th Cir. 1986) . . 12

Union Bank v. *Wolas*, 502 U.S. 151 (1991) 21, 27

United States v. *Ron Pair Enterprises*, 489 U.S. 235 (1989) 19, 20

W.A. Mallory Co., In re, 214 B.R. 834 (Bankr. E.D. Va. 1997) 29

Statutes

11 U.S.C. § 363 29

11 U.S.C. § 510(c) 23

11 U.S.C. § 1121 18

11 U.S.C. § 1126(c) 26, 27

11 U.S.C. § 1129(b) 1, 9, 11, 21

11 U.S.C. § 1129(b)(1) 27

11 U.S.C. § 1129(b)(2) 27

11 U.S.C. § 1129(b)(2)(B) 5, 8

11 U.S.C. § 1129(b)(2)(B)(ii) . . . . . *passim*

Bankruptcy Act of 1898, Chapters X, XI, and XII 26, 27

Other Authorities

John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963 (1989) 24

DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY (1993) . . . . . *passim*

Brian A. Basil, *The New Value Exception to Absolute Priority in Bankruptcy*, 101 COM. L.J. 290 (1996) 14, 29, 30

Walter J. Blum & Stanley A. Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. CHI. L. REV. 651 (1974) 30

5 COLLIER ON BANKRUPTCY ¶ 1129.03[e][i] (L. King 15th ed. 1996) 15

7 COLLIER ON BANKRUPTCY ¶ 1129.04[4][c] (L. King 15th ed. rev. 1997) 12, 15, 25

124 Cong. Rec. H11095 (daily ed. Sept. 28, 1978) . . . 23

124 Cong. Rec. S17412 (daily ed. Oct. 6, 1978) 23

Michelle Craig, Note & Comment, *The New Value Exception: A Plea for Modification or Elimination*, 11 BANKR. DEV. J. 781 (1995) 16

DAVID G. EPSTEIN, STEVE H. NICKLES, & JAMES J. WHITE, BANKRUPTCY (1993) 17, 18, 24, 27

Felix Frankfurter, *Some Reflections on the Reading of Statutes*, 47 Colum. L. Rev. 527 (1947) 23

Julie L. Friedberg, Comment, *Wanted Dead or Alive: The New Value Exception to the Absolute Priority Rule*, 66 TEMPLE L. REV. 893 (1993) 14

Salvatore G. Gangemi & Stephen Bordanaro, *The New Value Exception: Square Peg in a Round Hole*, 1 AM. BANKR. INST. L. REV. 173 (1993) 14, 26

Lawrence B. Gutcho, *Real Estate Lenders and the Battle over "New Value,"* 110 BANKING L.J. 423 (1993) 14, 15

Clifford S. Harris, Note, *A Rule Unvanquished: The New Value Exception to the Absolute Priority Rule*, 89 MICH. L. REV. 2301 (1991) 14

H.R. Rep. No. 95-595 (1977) 9

David R. Kuney & Timothy R. Epp, *Aftermath of* Bonner Mall: *Evolution or Regression in the Notion of "New Value"?*, 5 J. BANKR. L. & PRAC. 211 (1996) 16

Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69 (1991) 7, 8, 16, 24, 26

Michael H. Strub, Jr., *Competition, Bargaining, and Exclusivity Under the New Value Rule: Applying the Single-Asset Paradigm of Bonner Mall*, 111 BANKING L.J. 228 (1994) 12, 14, 16

J. Ronald Trost, et al., *Survey of the New Value Exception to the Absolute Priority Rule and the Preliminary Problem of Classification*, SB37 ALI-ABA 595 (1997) 13, 14, 16, 18, 22, 25

Jarlon Tsang, *The New Value Exception: Valuation Obstacles to the Absolute Priority Rule*, 14 ANN. REV. BANKING L. 361 (1995) 14, 16, 25

Elizabeth Warren, *A Theory of Absolute Priority*, 1991 ANN. SURVEY AM. LAW 9 14

PETITION FOR A WRIT OF CERTIORARI

Petitioner Bank of America National Trust and Savings Association, successor by merger to Bank of America Illinois (the "Bank"), respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit.

OPINIONS BELOW

The opinion of a divided panel of the court of appeals (App., *infra*, 1a-47a) is reported at 126 F.3d 955. The order of the court of appeals denying rehearing and denying rehearing en banc by a 5-5 vote (App., *infra*, 48a-49a) is not reported. The opinion of the district court (App., *infra*, 50a-101a) is reported at 195 B.R. 692. The opinion of the bankruptcy court (App., *infra*, 102a-154a) is reported at 190 B.R. 567.

JURISDICTION

The judgment of the court of appeals was entered on September 29, 1997. App., *infra*, 1a. A timely petition for rehearing was denied on November 25, 1997. App., *infra*, 48a-49a. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTE INVOLVED

11 U.S.C. § 1129(b) provides in pertinent part:

(1) * * * the court * * * shall confirm the plan * * * if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

(2) For the purpose of this subsection, the condition that a plan be fair and equitable * * * includes the following requirements:

* * *

(B) With respect to a class of unsecured claims —

(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

(ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

STATEMENT

A. The Absolute Priority Rule

The absolute priority rule in bankruptcy "provides that a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property [under a reorganization] plan." *Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 202 (1988) (internal quotation marks omitted). The rule was originally a judicial development but now is incorporated into the Bankruptcy Code, in 11 U.S.C. § 1129(b)(2)(B)(ii). *Ahlers*, 485 U.S. at 202.

Justice Douglas's opinion for the Court in *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106, 121-122 (1939), contained dicta that have been read to suggest that there was or is a new value exception to the absolute priority rule. *Ahlers*, 485 U.S. at 203. Such an exception, if it exists, would allow the debtor's pre-petition equity holders the right (perhaps the exclusive right) to retain an interest in the reorganized debtor, despite not providing for more senior classes in full, if a bankruptcy judge determines that they have made substantial new contributions in money or money's worth that are reasonably equivalent to the retained interest and necessary to a successful reorganization. App., *infra*, 14a.

The new value exception is difficult to reconcile with the language of Section 1129(b)(2)(B)(ii), which forbids pre-

petition equity holders to "receive or retain under the plan *on account of such junior claim or interest* any property" unless more senior interests consent or are paid in full (emphasis added). Accordingly, this Court in *Ahlers* left open the question whether any new value exception exists. 485 U.S. at 203 n.3. Proponents of the new value exception maintain, however, that it is not actually an "exception" but a "corollary" to the absolute priority rule, because the equity holders' post-petition interests are received "on account of" the contributed new value rather than "on account of" their pre-petition interest. See App., *infra*, 17a, 21a.

This case squarely presents the question left open in *Ahlers*. The Seventh Circuit not only held that a new value exception exists, but also applied it to confirm an otherwise-unconfirmable plan of reorganization. The court did so even though the debtors were given the *exclusive* opportunity to buy into the reorganized debtor by contributing new value.

B. Factual Background

The debtor in this case, respondent 203 North LaSalle Street Partnership, is a real estate limited partnership whose principal asset is fifteen floors of an office building in downtown Chicago (the "Property"). App., *infra*, 2a. The debtor owes the Bank more than $93 million; the debt is secured by a non-recourse first mortgage on the Property that came due in January 1995. *Ibid*. When the debtor was unable to repay the loan, the Bank began foreclosure proceedings; shortly thereafter, the debtor filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code. *Ibid*.

At the time the bankruptcy court confirmed the debtor's Chapter 11 plan of reorganization, the debtor was insolvent and the Bank's secured claim was valued at $54.5 million, leaving the Bank with an unsecured deficiency claim of $38.5 million. App., *infra*, 4a n.4, 115a. The bankruptcy court

found that the Property would not appreciate in value during the term of the plan such that (1) the debtor would ever become solvent, or (2) the Bank would ever receive payment in full of its unsecured claim. *Id.* at 133a. The bankruptcy court also found that the present value of what the Bank would ultimately receive on its unsecured claim under the plan was only about 16% of the Bank's unsecured $38.5 million claim. *Id.* at 28a, 133a. These findings were not disturbed on appeal.

In addition to ensuring that the Bank would never receive payment in full of its $38.5 million unsecured claim, the plan gave the debtor's pre-bankruptcy equity holders the *exclusive* right to retain their equity interests in the debtor if they contributed new capital, the cash or cash equivalent portion of which had a present value of $4.1 million, to be paid over five years.[1] App. *infra*, 4a, 24a, 34a, 111a-112a. Only the debtor's pre-petition equity holders were given the opportunity to contribute new capital in exchange for retention of an ownership interest in the reorganized debtor. *Ibid.*

The Bank, by far the debtor's largest creditor, objected to confirmation on the ground, among others, that the plan violated the absolute priority rule, because the debtor's pre-bankruptcy equity holders had the exclusive right to retain their equity interests in the debtor even though the Bank's senior, unsecured claim was not satisfied in full under the

---

[1] Although the ordinary rationale for Chapter 11 reorganization is to ensure that a business with going-concern value can continue in operation despite cash-flow problems that leave it temporarily unable to meet its obligations, that was not the rationale here. As the bankruptcy court specifically found, the partners who owned the debtor in this case were motivated by another consideration: they would owe some $20 million in income taxes if the Bank were permitted to foreclose. App., *infra*, 3a, 112a-113a.

plan. App., *infra*, 3a. The bankruptcy court nonetheless confirmed the plan; the court held that, although the plan ran afoul of the absolute priority rule, that rule was limited by the new value exception, which the plan satisfied. *Id.* at 135a-140a. The district court affirmed the bankruptcy court's decision. *Id.* at 79a-85a.

C. Proceedings In The Court Of Appeals

A divided Seventh Circuit panel upheld confirmation of the plan, holding among other things that the absolute priority rule codified at 11 U.S.C. § 1129(b)(2)(B) is subject to the new value exception (or new value "corollary"). App., *infra*, 13a-23a. Acknowledging that courts and commentators are "quite divided over this issue," *id.* at 18a n.8, the majority reasoned that

- This Court "established" the new value exception in *Case* v. *Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939), App., *infra*, 14a;
- "[F]or more than fifty years, the new value precept has been recognized as an important corollary or exception to the absolute priority rule," *id.* at 19a;
- When Congress adopted the Bankruptcy Code in 1978, there is "no question" that it "'must have enacted the Code with a full understanding' of the absolute priority rule and its new value corollary," *id.* at 20a; and
- Although "Congress did not explicitly codify the new value corollary" in the Code, the corollary "remains a part of our bankruptcy jurisprudence" because "Congress never explicitly declared * * * that it intended the

abolition" of the doctrine, *id.* at 15a, 20a-21a, 23a.

Judge Kanne dissented. To begin with, Judge Kanne explained, "the plain language of the absolute priority rule, *see* 11 U.S.C. § 1129(b)(2)(B)(ii), does not include a new value exception"; indeed, the statutory text "fails to even hint at" the existence of a new value exception. App., *infra*, 32a, 34a. Recognition of a new value exception is thus inconsistent with "the straightforward text of the statutory absolute priority rule." *Id.* at 38a.

In addition, Judge Kanne concluded that it is not reasonable to assume that Congress implicitly incorporated the new value exception into Section 1129(b)(2)(B)(ii), for two reasons. First, the new value exception rests on a "questionable foundation" under pre-Code law — dicta in *Case*, which "no reported case expressly adopted * * * as its holding until the Code's enactment in 1978" and which has since "'taken on a life of its own in the lower courts.'" *Id.* at 41a, 42a n.5. Second, the principles underlying the new value exception "differ greatly from those under the present Bankruptcy Code." *Id.* at 42a. Because of "the massive changes in bankruptcy procedures brought on by the Bankruptcy Code," "strict adherence to the pre-Code new value exception might *contravene* Congress's intent in codifying the absolute priority rule" and, at a minimum, does not indicate "Congress's intent to *include* a new value exception in § 1129(b)(2)(B)(ii)." *Id.* at 32a, 40a-41a (second emphasis added).

Only 10 of the 11 judges of the court of appeals considered the Bank's request for rehearing *en banc*. Judges Coffey, Easterbrook, Manion, Kanne, and Diane P. Wood voted to grant rehearing *en banc*, but the resultant 5-5 tie led to a denial of rehearing. App., *infra*, 48a-49a.

REASONS FOR GRANTING THE WRIT

Four years ago, this Court granted certiorari in *U.S. Bancorp Mortgage Co.* v. *Bonner Mall Partnership*, 513 U.S. 18 (1994), to decide an issue the Court left open in *Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 203 n.3 (1988): whether there is a new value exception to the absolute priority rule as codified in the Bankruptcy Code. That question is still unresolved. The Court did not decide the issue in *Bonner Mall* — it dismissed the case as moot after the parties settled, see 513 U.S. at 29 — and since then the validity of a new value exception has continued to be the subject of vigorous debate by judges and commentators alike. See App., *infra*, 18a n.8 (majority opinion), 35a n.2 (dissenting opinion). As one leading scholar has stated, the existence of a new value exception is "[o]ne of the great unresolved questions in the Bankruptcy Code." DOUGLAS G. BAIRD, THE ELEMENTS OF BANKRUPTCY 259 (1993). But until this Court provides a definitive answer to that question, "interpretative chaos reigns" in the lower federal courts. Bruce A. Markell, *Owners, Auctions, and Absolute Priority in Bankruptcy Reorganizations*, 44 STAN. L. REV. 69, 94 (1991).

The Seventh Circuit's ruling here conflicts directly with decisions of both the Second Circuit, *In re Coltex Loop Central Three Partners, L.P.*, No. 96-5140, slip op. 7-17 (2d Cir. Feb. 19, 1998), and the Fourth Circuit, *In re Bryson Properties*, 961 F.2d 496, 504-505 (4th Cir. 1992). The Second Circuit, in fact, has explicitly rejected the panel majority's holding in this case, instead adopting Judge Kanne's dissent. *Coltex*, slip op. 8 ("the reasoning for our conclusion has been explained very well by the dissent in *LaSalle*").

In both *Ahlers* and *Bonner Mall*, the United States appeared as amicus curiae and urged this Court to hold that the new value exception does not exist or, at a minimum, is

not so broad as to permit confirmation of a plan (such as the one here) in which the pre-petition equity holders receive the *exclusive* opportunity to receive a post-petition interest in return for an infusion of "new value." The government took that position in briefs signed by two different Solicitors General, appointed by two different Presidents. Thus, the Seventh Circuit's decision to allow confirmation of a "new value" plan featuring equity holder exclusivity conflicts with the considered views of the Executive Branch as well as decisions of the Second and Fourth Circuits and many lower courts.

The panel majority's decision also is at odds with the Bankruptcy Code. The existence of a new value exception is inconsistent with the plain language of Section 1129(b)(2)(B) as well as with the fundamental policy underlying the Bankruptcy Code: that the interests of creditors take precedence over the interests of an insolvent debtor's equity holders. The new value exception contravenes that policy by permitting an insolvent debtor's insiders — who no longer have any economic interest in the debtor's property — to grant themselves the exclusive opportunity to obtain interests in the reorganized property without having to worry about competitive bids from creditors or outsiders. As a result, during the negotiations that accompany any proposed plan of reorganization, bargaining leverage will be tilted heavily in favor of the insolvent debtor's equity holders and away from its creditors.

There is little to be gained from further consideration of the issue by lower levels of the judiciary. Hundreds of decisions and law review articles have discussed the new value exception in excruciating detail, considering every possible nuance of the issue. In the meantime, plans of reorganization that are premised on the existence of a new value exception are becoming increasingly common. Since 1978, "there has been an explosion of cases which discuss the new value 'exception' to the absolute priority rule." Markell, *supra*, 44

STAN. L. REV. at 93. This trend has continued in the four years since the Court granted certiorari in *Bonner Mall*.

Whether there is a new value exception to the absolute priority rule needs to be resolved once and for all. The question has enormous practical significance in reorganizations under Chapter 11 and is squarely presented by this case. The petition should be granted.

I. COURTS AND COMMENTATORS ARE SHARPLY DIVIDED ON THE VALIDITY OF A NEW VALUE EXCEPTION TO THE ABSOLUTE PRIORITY RULE

Unless a plan of reorganization provides for payment in full to a dissenting, senior class of unsecured creditors, the absolute priority rule prohibits the confirmation of any plan if a junior class of unsecured creditors or equity interest holders "receive[s] or retain[s] under the plan on account of such junior claim or interest *any property*." 11 U.S.C. § 1129(b)(2)(B)(ii) (emphasis added). See also *Ahlers*, 485 U.S. at 202 ("'a dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property [under a reorganization] plan'"). Twice in recent years, this Court has expressly left open whether the absolute priority rule is subject to a new value exception. *Id.* at 203 n.3; *Bonner Mall*, 513 U.S. at 20 n.1. Since *Ahlers*, the lower federal courts have provided flatly inconsistent answers to that question.

1. It cannot seriously be doubted that the exclusive right to retain an equity interest in a business enterprise is "property" within the meaning of Section 1129(b)(2)(B)(ii). "[W]hile the Code itself does not define what 'property' means as the term is used in § 1129(b), the relevant legislative history suggests that Congress' meaning was quite broad," and included "'both tangible and intangible property.'" *Ahlers*, 485 U.S. at 208 (quoting H.R. Rep. No. 95-

595, at 413 (1977)). Thus, "[e]ven where debts far exceed the current value of assets, a debtor who retains his equity interest in the enterprise retains 'property.'" *Id.* at 207-208. See also, *e.g.*, *Kham & Nate's Shoes No. 2, Inc.* v. *First Bank*, 908 F.2d 1351, 1360 (7th Cir. 1990) ("[a]n option to purchase stock also is 'property'" under § 1129(b)).

The Second and Fourth Circuits have relied on this broad definition of property in overturning confirmations of plans of reorganization that were the same in all material respects as the plan upheld by the Seventh Circuit in this case. Like the plan here, the *Coltex* and *Bryson* plans provided the debtor's pre-bankruptcy equity holders with the exclusive right to contribute new capital to, and receive equity interests in, the reorganized debtor, while at the same time denying full payment to senior classes of unsecured creditors. *Coltex*, slip op. 9; *Bryson*, 961 F.2d at 504-505. Applying what each court held was "plain" statutory language, the Second and Fourth Circuits ruled that the plans violated the absolute priority rule. See *Coltex*, slip op. 9 ("the *exclusive* right to retain the debtor's property upon making a capital contribution is itself property," which was received "on account of equity's prior position"); *Bryson*, 961 F.2d at 504 (the "exclusive right to contribute [new capital] constitutes 'property' under § 1129(b)(2)(B)(ii), which was received or retained on account of a prior interest").[2]

---

[2] In *Bryson*, the Fourth Circuit also noted in passing that the proposed plan gave the equity holders "the right to return of their new capital prior to [the senior creditor's] recovery of its unsecured claim," 961 F.2d at 504, but that fact played no role in the court's ultimate holding. Rather, the court stated that its decision turned on "whether the equityholders receive[d] anything 'on account of' their prior interest" — and the only "'property'" that the court held "was received or retained on account of a prior interest" was the

(continued...)

On the same operative facts, the panel majority here reached precisely the opposite conclusion. The majority held that a plan that offered the debtor's prior equity owners the exclusive right to retain their ownership interests, in exchange for a contribution of new capital, passed muster under the Bankruptcy Code because the new value exception "remains a part of our bankruptcy jurisprudence." App., *infra*, 23a.

The panel majority's holding conflicts directly with the decisions of the Second and Fourth Circuits. The *Coltex* court expressly agreed with the dissent in this case. The *Bryson* court stopped short of holding that the new value exception is not embodied in Section 1129(b), but its holding would require a different outcome in this case than the one reached by the Seventh Circuit. Both the Second and Fourth Circuits concluded that, even if a limited new value exception existed under the Code, it would not apply when a plan gave prior equity owners the *exclusive* opportunity to contribute new capital and receive or retain an equity interest in the reorganized business. *Coltex*, slip op. 13-14, 17; *Bryson*, 961 F.2d at 505. The same *exclusive* opportunity for prior equity holders exists in this case and in most other Chapter 11 proceedings in which a new value plan is proposed (including *Bonner Mall*).[3] See, *e.g.*, BAIRD, ELEMENTS OF BANKRUPTCY

---

[2] (...continued)
"exclusive right to *contribute*" new capital. *Ibid.* (emphasis added). In *Coltex*, the Second Circuit speculated that in the Seventh Circuit's *LaSalle* decision "it does not appear that the lender attempted to file a competing plan." Slip op. 7 n.1. In fact, the Bank *did* move to file a competing plan of reorganization here; the bankruptcy court denied that request. BAI R. 104.

[3] For extensive criticism of the Ninth Circuit's *Bonner Mall* decision (equally applicable to this case) on the ground that it

(continued...)

at 261. Had the present case arisen in the Second Circuit or the Fourth Circuit, those courts would have rejected the same plan of reorganization that the Seventh Circuit accepted.

2. In other cases, as well, the courts of appeals have expressed divergent views on whether there is a new value exception to the absolute priority rule. Before the Seventh Circuit's ruling here, the Ninth Circuit — in the case this Court agreed to review, but ultimately did not decide, in *Bonner Mall* — was the only court of appeals to have concluded that the new value exception continues to exist. *In re Bonner Mall Partnership*, 2 F.3d 899, 906-918 (9th Cir. 1993). See also *In re U.S. Truck Co.*, 800 F.2d 581, 588 (6th Cir. 1986) (a pre-*Ahlers* decision, assuming without analysis that a new value exception exists).

But, as the Ninth Circuit recognized in *Bonner Mall*, other courts of appeals have taken different positions on whether there is a new value exception to the absolute priority rule. 2 F.3d at 901 ("dicta in several opinions demonstrate intra- and inter-circuit disagreements" on the question). See also *Coltex*, slip op. 7 (the "courts of appeal * * * have employed different reasoning to reach variable results"); 7 COLLIER ON BANKRUPTCY ¶ 1129.04[4][c], at 1129-102 (L. King 15th ed. rev. 1997) ("One of the more hotly contested issues after adoption of the Code has been whether the so-called 'new value' cases continued to have validity. * * * [T]he circuits are currently in disarray.").

---

[3] (...continued)
allowed debtor exclusivity while simultaneously maintaining that the debtor was receiving nothing of value "on account of" pre-petition interests, see Michael H. Strub, Jr., *Competition, Bargaining, and Exclusivity Under the New Value Rule: Applying the Single-Asset Paradigm of Bonner Mall*, 111 BANKING L.J. 228 (1994). See also Brief for the United States as Amicus Curiae at 25-30, *Bonner Mall* (No. 93-714).

In addition to the decisions of the Second and Fourth Circuits, a Fifth Circuit panel held flatly that the new value exception does not exist under the Bankruptcy Code. *In re Greystone III Joint Venture*, 995 F.2d 1274, 1282-1284 (5th Cir. 1991). The relevant portion of the opinion was later vacated by the panel, but Judge Jones (author of the panel opinion) vigorously dissented: "[I]n reaffirming what I wrote about the 'new value exception' in Part IV of the original opinion, * * * I would hope to stand with Galileo, who, rebuffed by a higher temporal authority, muttered under his breath, 'Eppur si muove.' ('And yet it moves.')." *Id.* at 1285. And, before the panel decision in this case, another Seventh Circuit panel strongly suggested, but did not decide, that the new value exception did not survive the codification of the absolute priority rule in 1978. *Kham & Nate's Shoes*, 908 F.2d at 1360-1362.

3. There is also a pronounced disagreement among district and bankruptcy courts concerning the new value exception. The Ninth Circuit noted in *Bonner Mall* that "[d]istrict and bankruptcy courts are sharply divided on the question * * *. The question will in all probability be decided by the Supreme Court." 2 F.3d at 901. The panel majority here echoed that observation: "The district and bankruptcy courts are quite divided over this issue." App., *infra*, 18a n.8. See also *Bryson*, 961 F.2d at 503 ("courts are divided as to whether codification of the absolute priority rule * * * tolled a death knell for the [new value] exception"); J. Ronald Trost, et al., *Survey of the New Value Exception to the Absolute Priority Rule and the Preliminary Problem of Classification*, SB37 ALI-ABA 595, 677-699 (1997) (available on Westlaw) (collecting more than 100 published post-*Ahlers* decisions discussing whether a new value exception exists).

4. Bankruptcy scholars similarly dispute whether there is a new value exception to the absolute priority rule. See

App., *infra*, 18a n.8 ("[a]cademics and commentators, too, have not agreed on the issue") (citing articles on each side of the debate); *Bonner Mall*, 2 F.3d at 901 (commentators are "sharply divided on the question").[4] Many of the most thoughtful commentaries conclude — contrary to the Seventh Circuit here — that there is no such exception under the Code.[5] Others conclude — also inconsistently with the Seventh Circuit's position — that, if any such exception exists, it must not be applied so as to allow the debtor the *exclusive* right to infuse new equity.[6] The editors of one

---

[4] See also, *e.g.*, Trost, et al., *supra*, SB37 ALI-ABA at 603 ("The viability of new value plans under the Code has been hotly debated by courts and commentators"); Jarlon Tsang, *The New Value Exception: Valuation Obstacles to the Absolute Priority Rule*, 14 ANN. REV. BANKING L. 361, 369 (1995) (the Court's decision in *Ahlers* "ignited judicial and academic debate on [an] issue already clouded with uncertainty"); Salvatore G. Gangemi & Stephen Bordanaro, *The New Value Exception: Square Peg in a Round Hole*, 1 AM. BANKR. INST. L. REV. 173, 179 (1993) (*Ahlers* "has caused extensive comment within the legal community and much division among lower courts"); Clifford S. Harris, Note, *A Rule Unvanquished: The New Value Exception to the Absolute Priority Rule*, 89 MICH. L. REV. 2301, 2312 (1991) ("A significant divergence of opinion concerning the viability of the new value rule has developed in the courts since *Ahlers*.").

[5] See, *e.g.*, Brian A. Basil, *The New Value Exception to Absolute Priority in Bankruptcy*, 101 COM. L.J. 290 (1996); Lawrence B. Gutcho, *Real Estate Lenders and the Battle over "New Value,"* 110 BANKING L.J. 423 (1993); Julie L. Friedberg, Comment, *Wanted Dead or Alive: The New Value Exception to the Absolute Priority Rule*, 66 TEMPLE L. REV. 893 (1993).

[6] See, *e.g.*, Strub, *supra*, 111 BANKING L.J. 228; Elizabeth Warren, *A Theory of Absolute Priority*, 1991 ANN. SURVEY AM. (continued...)

treatise find the issue so close that they have reached opposite conclusions in consecutive revisions of the same edition. Compare 7 COLLIER ON BANKRUPTCY ¶ 1129.04[4][c][iii], at 1129-117 to 1129-119 (L. King 15th ed. rev. 1997) (concluding that exception exists) with 5 COLLIER ON BANKRUPTCY ¶ 1129.03[e][i], at 1129-101 to 1129-102 (L. King 15th ed. 1996) (concluding that exception does not exist). This is manifestly an issue in need of resolution by this Court.

* * *

It has been nearly a decade since this Court left open the validity of the new value exception in *Ahlers*. After ten years of spirited debate, the federal courts and the commentators are in disarray on the issue. The differences are clear and well developed, and additional reflection by the lower courts is unlikely to result in a consensus view. It is time for this Court to resolve the question.

II. WHETHER THERE IS A NEW VALUE EXCEPTION TO THE ABSOLUTE PRIORITY RULE IS AN IMPORTANT AND RECURRING ISSUE

When this Court granted certiorari in *Bonner Mall*, it recognized the importance of deciding sooner rather than later whether the new value exception exists. Unfortunately, the parties' settlement left the Court unable to resolve the issue in that case. But it is just as true now as it was at the time of *Bonner Mall* that "[t]he 'new value' issue is perhaps the single most important bankruptcy law issue facing lenders today." Gutcho, *supra*, 110 BANKING L.J. at 423. "The split among and even within the circuits as to the viability of the exception has created unpredictability for debtors and the

---

[6] (...continued)
LAW 9, 39.

courts." Michelle Craig, Note & Comment, *The New Value Exception: A Plea for Modification or Elimination*, 11 BANKR. DEV. J. 781, 788 (1995). "Confusion over the absolute priority rule is deplorable, especially when the rule is fundamental to reorganization." Markell, *supra,* 44 STAN. L. REV. at 96.

It is particularly important that this Court rule on whether a new value exception exists because the question arises with such frequency in Chapter 11 proceedings. From the time this Court's decision in *Ahlers* first "caused a furor among lower courts," Markell, *supra*, 44 STAN. L. REV. at 95, until May 1997, federal courts published more than 100 decisions discussing the viability of a new value exception. See Trost, et al., *supra*, SB37 ALI-ABA at 677-699 (listing published rulings — the survey does not include unpublished decisions). The issue has also generated considerable scholarly debate. See *id.* at 672-676 (bibliography of relevant articles). "Few topics in bankruptcy have generated as much literature as the new value or fresh capital 'exception' to the absolute priority rule." Strub, *supra,* 111 BANKING L.J. at 233; see also, *e.g.*, Tsang, *supra,* 14 ANN. REV. BANKING L. at 363 ("the new value exception is one of the most actively debated issues in bankruptcy").

As suggested by the sheer number of judicial decisions and academic commentaries on the topic, whether there is a new value exception to the absolute priority rule is an issue of "enormous practical import." Strub, *supra,* 111 BANKING L.J. at 233. Indeed, "[t]he issue of new value is critical because the principles underlying this concept are at the very core of bankruptcy law and the notion of reorganization." David R. Kuney & Timothy R. Epp, *Aftermath of* Bonner Mall: *Evolution or Regression in the Notion of "New Value"?*, 5 J. BANKR. L. & PRAC. 211, 211 (1996).

"Negotiations are the lifeblood of a corporate reorganization," BAIRD, ELEMENTS OF BANKRUPTCY at 266,

and whether there is a new value exception will have a profound effect on the course of those negotiations. As the Ninth Circuit summarized in *Bonner Mall*, "[w]hether this doctrine is viable under the Bankruptcy Code has significant implications for the relative bargaining power of debtors and creditors in Chapter 11 cases." 2 F.3d at 901.

This is because the absolute priority rule, when "applied rigorously," acts as a "powerful brake on the debtor's behavior and a strong influence on the negotiation that is likely to occur over a reorganization plan" — it "make[s] the debtor more willing to negotiate" with creditors. DAVID G. EPSTEIN, STEVE H. NICKLES, & JAMES J. WHITE, BANKRUPTCY 839 (1993). If the absolute priority rule is watered down with a new value exception, there is a risk that the debtor's appraiser will convince "a sympathetic judge * * * that the value of the property in the bankruptcy estate is much lower than the creditors believe it to be." *Ibid.* See also BAIRD, ELEMENTS OF BANKRUPTCY at 266 ("the most serious danger that the new value exception introduces is that the judge will put a value on the firm that is too low"). This will decrease the amount paid to creditors, while at the same time permitting the debtor's pre-bankruptcy equity holders to retain an ownership interest in the post-bankruptcy business at a bargain price. EPSTEIN, ET AL., BANKRUPTCY at 839; BAIRD, ELEMENTS OF BANKRUPTCY at 262-263, 266. "The shareholders will be getting a good deal at the creditors' expense," *id.* at 266, or, at a minimum, will be able to impose a plan of reorganization that dissenting classes of senior creditors have concluded is not in their best interests. See *Greystone*, 995 F.2d at 1284-1285 (Jones, J., dissenting) ("Negotiations between creditors and the debtor against such a 'new value exception' backdrop would be enormously skewed in favor of old equity and would seriously erode the utility of the creditors' votes."). If, on the other hand, the absolute priority rule is "applied rigorously," each class of

creditors can protect itself against the possibility of a "small recovery" (or an otherwise unacceptable reorganization scheme) by "vetoing the plan." EPSTEIN, ET AL., BANKRUPTCY at 839.[7]

The "threat" of a new value plan "is often a powerful consideration at the negotiating table," Trost, et al., *supra*, SB37 ALI-ABA at 620, and thus the negotiations that occur in all Chapter 11 proceedings will be shaped largely by whether or not the absolute priority rule is limited by a new value exception. In the end, the identity of the constituency that will determine the ultimate outcome of Chapter 11 cases when the debtor is insolvent — senior, unsecured creditors or the debtor's pre-bankruptcy equity holders — will depend on the answer to the question presented in this case.

III. THE PANEL MAJORITY'S DECISION IS FUNDAMENTALLY FLAWED

In addition to being inconsistent with the decisions of other courts, the panel majority's holding is seriously flawed. The language enacted by Congress in 1978 does not contain a single reference to the new value exception. Congress was

---

[7] In enacting the Bankruptcy Code, Congress intended to promote consensual plans, but at the same time maintain the integrity of the absolute priority rule. It did so by granting the debtor the exclusive initial right to propose a plan of reorganization, see 11 U.S.C. § 1121, but providing that a plan ultimately could not be confirmed without satisfying the absolute priority rule. Thus, Congress placed the initial bargaining leverage in the hands of the debtor through its initial exclusive right to propose a plan, but intended the *ultimate* leverage to be with the creditors pursuant to the absolute priority rule. See generally *Coltex*, slip op. 13 (discussing "the balance sought to be achieved by Congress" in Chapter 11). The decision of the panel majority eviscerates this congressional design by vesting both the initial and ultimate leverage in the debtor's pre-bankruptcy equity holders.

not silent on how it wanted the absolute priority rule applied: the plain terms of the statute list the ways in which a plan can be crammed down on unconsenting creditors, and the new value exception is not among them. There is still less basis for postulating congressional "silence" and interpreting it as tacit acceptance of well-settled doctrine. On the contrary, the exception rests on the shakiest of legal foundations: a dictum that had never been the basis for the holding of *any* reported decision before adoption of the Bankruptcy Code nearly 40 years later. What is more, the legal landscape that prompted the suggestion of a new value exception in 1939 is fundamentally different from the law of bankruptcy that exists today. Finally, the new value exception violates basic principles of bankruptcy law; it permits those at the bottom of the priority ladder to control the debtor's property to the detriment of impaired creditors with a higher priority.

A. The Plain Statutory Language Does Not Include A New Value Exception

The "cardinal canon" of statutory construction is that "courts must presume that a legislature says in a statute what it means and means in a statute what it says there." *Connecticut Nat'l Bank* v. *Germain*, 503 U.S. 249, 253-254 (1992). Thus, when a statute is unambiguous, judicial inquiry begins and ends with "the words of [the] statute." *Id.* at 254. In a case involving interpretation of the Bankruptcy Code, no less than any other statute, when "the statute's language is plain, 'the sole function of the courts is to enforce it according to its terms.'" *United States* v. *Ron Pair Enterprises*, 489 U.S. 235, 241 (1989) (quoting *Caminetti* v. *United States*, 242 U.S. 470, 485 (1917)).

The statute here is unambiguous. Section 1129(b)(2)(B)(ii) states that a plan that does not provide a dissenting class of unsecured creditors with property of a value equal to the amount of their claims *cannot* be confirmed unless "the holder of any claim or interest that is junior to the

claims of such class will not receive or retain under the plan on account of such junior claim or interest *any property*." (Emphasis added.) The language is unequivocal; it does not allow a junior class to receive "any" property "on account of" its pre-petition interest until senior classes are paid in full. Nor is there the slightest indication in the statute that the broad prohibition on the receipt of "any" property by junior classes is qualified by any type of exception. See *Bates* v. *United States*, 118 S. Ct. 285, 290 (1997) ("we ordinarily resist reading words or elements into a statute that do not appear on its face").

The court below, and other proponents of a new value exception, have attempted to find ambiguity in the statutory language through two devices. The first is the purest bootstrapping: because courts and commentators have differed about whether the new value exception exists, there *must* be ambiguity. See, *e.g.*, App., *infra*, 18a-19a. But that one-way ratchet, which renders the Bankruptcy Code more and more ambiguous whenever courts purport to find ambiguity in it leading to different constructions, is the path to interpretive chaos — not just in this case, but in every case involving any issue of even the slightest difficulty under the Code. Moreover, the approach cannot be reconciled with this Court's decisions. In *Ron Pair*, for example, the majority found the Code unambiguous even though four Justices thought that the better construction was the one rejected by the majority. As Judge Kanne rightly pointed out, *all* of this Court's bankruptcy decisions "command courts to apply a statute's unambiguous language without looking beyond it." *Id.* at 38a.[8]

---

[8] The panel majority relied in part on the notion that past bankruptcy practice cannot be disregarded "absent a clear indication that Congress intended to break from those practices." App., *infra*, (continued...)

The second argument often advanced to try to fit the new value exception within the statutory language is that the equity holders' post-petition interest is not received or retained "on account of" their pre-petition interest but rather "on account of" the new value they contribute. See, *e.g.*, App., *infra*, 17a, 21a. That argument suffers from the flaw of assuming that there is an inconsistency between occurring "on account of" one thing and *also* occurring "on account of" something else. For example, Justices sit on this Court "on account of" their appointment by the President, but they also enjoy their positions "on account of" confirmation by the Senate. It would be absurd to claim that a Member of this Court does not hold his or her seat "on account of" presidential appointment merely because it is *also* true that senatorial

---

[8] (...continued)
20a. But as the Second Circuit recognized in *Coltex*, slip op. 10, this Court has stressed that the unambiguous words of a statute must be applied even when the statute changes established pre-Code practice. See *Dewsnup* v. *Timm*, 502 U.S. 410, 419-420 (1992) ("Of course, where the language is unambiguous, silence in the legislative history cannot be controlling"); *Pennsylvania Dep't of Public Welfare* v. *Davenport*, 495 U.S. 552, 560-564 (1990) (enforcing plain meaning of Bankruptcy Code provision even though it abrogated pre-Code practice). Applying the plain language of Section 1129(b) is particularly warranted here because there is no affirmative support in the Code's legislative history for the continued existence of the new value exception. See *Kham & Nate's Shoes*, 908 F.2d at 1361-1362. The complete absence of supporting legislative history distinguishes this case from *Dewsnup*, where there was legislative history indicating that Congress intended the pre-Code practice to survive. 502 U.S. at 419. See also *Union Bank* v. *Wolas*, 502 U.S. 151, 159 & n.14 (1991) (rejecting the argument that Congress intended to codify pre-Code law where the statute itself gave no such indication and the legislative history "does not even mention" the pre-Code practice).

confirmation is necessary. So too in this case, the equity holders enjoy their post-petition interest under the plan "on account of" *both* their prior equity positions and their promise to contribute new value — in contravention of the plain language of Section 1129(b)(2)(B)(ii).

That is especially clear in this case because the debtor's pre-petition equity holders were given the *exclusive* right to propose a plan involving their own new contributions. Whatever force the "on account of" argument might have when an auction of some sort is held (see *In re Homestead Partners, Ltd.*, 197 B.R. 706, 714-716 & n.9 (Bankr. N.D. Ga. 1996)),[9] it falls apart when the equity holders' pre-petition interest gives them the *exclusive* right to participate over creditor dissent by providing "new value." See *Coltex*, slip op. 14 (explaining that the new value exception permits insiders to obtain the debtor's property at a "bargain" price "untested by market forces").

As noted earlier, the right of the debtor's partners to retain their equity interests is "property" for purposes of this section. See pp. 9-10, *supra*. Moreover, this is "property" that is to be received or retained "on account of" the partners' pre-petition ownership in the debtor. On the facts of this case, they are receiving this *exclusive* opportunity *solely* "on account of" their prior equity interests in the debtor. Prior equity holders are the *only* persons permitted to make such an investment; other investors are barred from doing so. See App., *infra*, 34a (Kanne, J., dissenting); *Coltex*, slip op. 9-11; *Bryson*, 961 F.2d at 504-505; *Greystone*, 995 F.2d at 1283, 1285 (Jones, J., dissenting).

---

[9] For a fuller listing of cases suggesting an auction "solution," see Trost, et al., *supra*, SB37 ALI-ABA at 651-652 & nn.208-211, 658 & nn.242-243, 666-667 & nn.281-293.

Had Congress wanted to include a new value exception in the Bankruptcy Code, it could have done so easily. It did not. See Felix Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COLUM. L. REV. 527, 536 (1947) (in interpreting a statute, "[o]ne must * * * listen attentively to what it does *not* say") (emphasis added).[10] As enacted, the Code "strikes a considered balance between creditor and debtor interests, which creditors, debtors, and courts must scrupulously respect." *Coltex*, slip op. 13. Courts "must enforce the statute according to its terms," *Patterson* v. *Shumate*, 504 U.S. 753, 759 (1992), and by its terms, the Bankruptcy Code simply does not include a new value exception to the absolute priority rule — certainly not one broad enough to allow the pre-petition equity holders to enjoy the exclusive right to contribute new value that they were accorded here.

---

[10] Having made no mention of any new value exception in the statute, Congress, of course, provided no guidance as to the content of any such exception. Any such development, therefore, must occur entirely in the courts. But Congress knows how to say when it intends such judicial development of the content of a Bankruptcy Code provision. See, *e.g.*, 124 Cong. Rec. H11095 (daily ed. Sept. 28, 1978) ("It is intended that the in term 'principles of equitable subordination' [in 11 U.S.C. § 510(c)] follow existing case law and leave to the courts development of this principle"); *id.* at S17412 (daily ed. Oct. 6, 1978) (same). That Congress did not do so here reinforces the conclusion that it intended the codified absolute priority rule to be enforced as written, not to be subject to an exception — uncodified and unmentioned in the legislative history — to be developed by the courts.

B. Congress Did Not Adopt The New Value Exception *Sub Silentio* When It Enacted The Bankruptcy Code In 1978

The panel majority's decision rested on its belief that this Court "established" the new value exception in 1939, and that when Congress enacted the Bankruptcy Code nearly 40 years later, it "must have" done so with a "full understanding" of this doctrine, which "has long been ensconced in our bankruptcy practice." App., *infra*, 14a, 20a. None of the panel majority's premises is correct.

1. This Court has never "established" a new value exception. The exception is rooted in dicta found in Justice Douglas's opinion for the Court in *Case* v. *Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 121-122 (1939). But the Court has never adopted those dicta as the basis for the holding in any case; as Judge Easterbrook has noted, "[s]o far as the Supreme Court is concerned," the development of the new value exception "has been 100% dicta." *Kham & Nate's Shoes*, 908 F.2d at 1360.[11]

2. Nor was the doctrine "established" in the lower courts before 1978. As the Second Circuit and Judge Kanne have noted, *Coltex*, slip op. 11; App., *infra*, 42a n.5, before Congress adopted the Bankruptcy Code in 1978, "*no* reported case seems to have adopted Justice Douglas' dicta as its holding," Markell, *supra*, 44 STAN. L. REV. at 92 (emphasis added). Accord, *e.g.*, Ayer, *supra*, 87 MICH. L. REV. at 1016 ("Justice Douglas' supposed 'exception' * * * is

---

[11] Moreover, it is generally understood that the *Case* dicta themselves are "based on a misunderstanding of earlier law." BAIRD, ELEMENTS OF BANKRUPTCY at 263. See also App., *infra*, 41a; *Kham & Nate's Shoes*, 908 F.2d at 1360-1361; EPSTEIN, ET AL., BANKRUPTCY at 841-843; John D. Ayer, *Rethinking Absolute Priority After Ahlers*, 87 MICH. L. REV. 963, 999-1007 (1989).

nowhere present as a rule of decision in Chapter X cases [under the prior statute, the Bankruptcy Act of 1898]. New value under Chapter X, then, is an illusion."); Tsang, *supra*, 14 ANN. REV. BANKING L. at 368 ("Prior to the revisions of the Code, the new value exception espoused in *Case* had appeared in no reported cases. After * * * 1978, litigation over the existence and application of the new value exception exploded in the lower courts."). In short, at the time Congress enacted the Bankruptcy Code, the *Case* dicta were "seemingly moribund." 7 COLLIER ON BANKRUPTCY ¶ 1129.04[4][c][i][A], at 1129-108. Given the absence of any reported decision before 1978 purporting to apply the exception, the panel majority's statement that "the new value exception traditionally has played" a "major role * * * in the bankruptcy field," App., *infra*, 20a, is dubious at best.[12]

3. In addition to the fact that *Case*'s remarks about new value were dicta, not a holding, and that no published decision had ever adopted those dicta as the basis for a holding in the ensuing 40 years, there is another reason why congressional "silence" on the new value exception in enacting the Bankruptcy Code cannot be taken as tacit acquiescence of the exception. The bankruptcy scheme that existed in 1939 — and that prompted the *Case* dicta — was vastly different from the Bankruptcy Code adopted in 1978.

---

[12] Since *Ahlers* began the current furor over new value, very few new value plans have actually been confirmed, but the vast majority of those that have been confirmed — including the plan in the present case — have been confirmed very recently. See Trost, et al., *supra*, SP[illegible] ALI-ABA at 619 & n.77, 644 & n.174. Thus, ironically, the [illegible]kruptcy Code, whose language and structure are far more inhospitable to any new value exception than pre-Code law, is being construed to allow *greater* practical opportunities to buy into a reorganized business over creditors' objections than the prior law.

Before enactment of the Bankruptcy Code, bankruptcy proceedings had been governed by the Bankruptcy Act of 1898, which contained three rehabilitative chapters, Chapters X, XI, and XII. Each chapter differed from the others with respect to the standards that had to be met in order to confirm a plan over a dissenting class of unsecured claims, commonly known as "cramdown." Chapter X (and its predecessor, Section 77B) authorized a court to approve a plan only if it was "fair and equitable," but the statute did not define that phrase. *Case*, 308 U.S. at 114-115. Chapter X also required *unanimous* consent of all creditors to confirm a plan. *Ibid.* It was against this backdrop, in the course of elucidating the meaning of the "fair and equitable" requirement, that Justice Douglas suggested that there might be a judicially created exception to the absolute priority rule. *Id.* at 114-121.

Two other rehabilitative chapters also existed before adoption of the Bankruptcy Code. Under Chapter XI, as amended in 1952, there was no "fair and equitable" requirement; thus, "the absolute priority rule did not apply in Chapter XI proceedings," and new value issues "never arose." Markell, *supra*, 44 STAN. L. REV. at 92 & n.152. Chapter XII, which dealt with real estate reorganizations, also "did not require that a plan conform to the absolute priority rule" after the statute was amended in 1952, and thus new value was not an issue under Chapter XII either. Gangemi & Bordanaro, *supra*, 1 AM. BANKR. INST. L. REV. at 188 & n.106.

When Congress enacted the Bankruptcy Code in 1978, it "radically altered reorganization strategy," Markell, *supra*, 44 STAN. L. REV. at 123, in ways that removed any need or basis for the new value exception proposed in *Case*. Congress replaced three disparate statutory schemes with a single one, Chapter 11. The statute no longer required unanimous class consent to confirm a plan, 11 U.S.C. § 1126(c), and the "fair and equitable" test applied only if class acceptance did not

occur, 11 U.S.C. § 1129(b)(1). These changes mean that, if *Case* arose today, a new value exception would not be needed to ensure continued shareholder control; the vote in that case — approval by more than 90% of each class of creditors, 308 U.S. at 111-112 — would satisfy Section 1126(c) of the current Code. BAIRD, ELEMENTS OF BANKRUPTCY at 262. Finally, the Code — unlike Chapter X — includes an elaborate definition of the "fair and equitable" standard. 11 U.S.C. § 1129(b)(2). Nothing in that definition, however, mirrors the new value dictum articulated in *Case*.

These features of Chapter 11 "represent[] a significant change from pre-Code bankruptcy law and arguably render[] the new value exception unnecessary." App., *infra*, 43a (Kanne, J., dissenting); see also *Greystone*, 995 F.2d at 1282, 1285 (Jones, J., dissenting); EPSTEIN, ET AL., BANKRUPTCY at 844-845. In fact, as Judge Kanne concluded, "cutting and pasting pre-Code practice into a fundamentally different bankruptcy context" results in a "new" statute "that Congress likely never intended." App., *infra*, 46a; see also *Coltex*, slip op. 11-13. In light of the dramatic changes made in 1978 to the statutory framework for business reorganizations, there is no basis for concluding that Congress meant to continue the use of a doctrine founded on dicta written in a significantly different legal environment — particularly when those dicta had never been followed in the four ensuing decades. See *Wolas*, 502 U.S. at 160 (given the "substantial changes in the preference provision, there is no reason to assume" that pre-Code rules should apply under the 1978 Code).

C. A New Value Exception Would Be Inconsistent With The Policies Underlying The Bankruptcy Code

Besides having no basis in the statutory text, the new value exception adopted by the Seventh Circuit is inconsistent with basic Bankruptcy Code principles. To begin with, a new value exception would turn the bankruptcy priority scheme on

its head. The exception not only permits prior equity holders to participate in the reorganized entity, but it gives the parties in interest with the *lowest* legal priority the ultimate right to control a debtor and its property, even if their pre-petition economic position in the debtor has become valueless and senior, unsecured creditors will not receive payment in full of their claims. Cf. *CFTC* v. *Weintraub*, 471 U.S. 343, 355 (1985) ("One of the painful facts of bankruptcy is that the interests of shareholders become subordinated to the interests of creditors").

This is contrary to a fundamental precept of the Bankruptcy Code. "Creditors effectively own bankrupt firms," *Kham & Nate's Shoes*, 908 F.2d at 1360, and "the Code provides that it is up to the creditors — and not the courts — to accept or reject a reorganization plan which fails to provide them adequate protection or fails to honor the absolute priority rule," *Ahlers*, 485 U.S. at 207. See also *Greystone*, 995 F.2d at 1283-1285 (Jones, J., dissenting). The new value exception reverses the roles of creditors and courts. It "means a power in the judge to 'sell' stock to the managers even when the creditors believe that this transaction will not augment the value of the firm," *Kham & Nate's Shoes*, 908 F.2d at 1360, or otherwise be in their best interests. See also *Coltex*, slip op. 17 (approving a new value plan "for the benefit of insiders" would stymie a creditor "in its legitimate attempts to obtain the value of its claims"). And because of the deferential standard of review, "each bankruptcy court can impose its freewheeling view of reorganization policy without fear of appellate reversal." *Greystone*, 995 F.2d at 1284-1285 (Jones, J., dissenting). The Code does not give bankruptcy judges this power.

As applied in this and many similar cases involving debtor exclusivity, moreover, the new value exception permits the debtor's insiders effectively to sell the debtor's property to themselves on their own chosen terms. The only check on

abuse of that power is a bankruptcy judge's necessarily imperfect attempt at valuation — rather than the market discipline that would be provided if there were competitive bids from creditors or outsiders. See *Coltex*, slip op. 12 (noting the danger of "self-dealing"). No provision in Chapter 11 of the Code permits this type of self-interested conduct by the debtor's owners. See *In re A.V.B.I., Inc.*, 143 B.R. 738, 747 (Bankr. C.D. Cal. 1992). Indeed, case law under 11 U.S.C. § 363, the principal Code provision governing the sale of assets, flatly prohibits such closed, insider-only sales. *E.g.*, *In re W.A. Mallory Co.*, 214 B.R. 834, 838 (Bankr. E.D. Va. 1997).

The panel majority speculated, without citation, that the new value exception "has been a major source of new funding in reorganizations for the past fifty years" and that the absence of a new value exception might threaten "the continued existence[] of many corporate entities." App., *infra*, 21a. On its face, this is a questionable proposition, given that there are *no* reported cases before 1978 approving a plan of reorganization incorporating the new value exception. In any event, the absolute priority rule does not bar prior equity holders from providing new capital; it only prohibits the pre-bankruptcy shareholders from having the exclusive or prior option of retaining control of the reorganized business *over the objections of a senior class of impaired unsecured creditors*. Creditors will *consent* to a plan that involves an infusion of new value when, in their estimation, it truly is in the best interests of creditors and the estate. See *Kham & Nate's Shoes*, 908 F.2d at 1360; Basil, *supra*, 101 COM. L.J. at 303-304 & n.83. The true policy issue in new value cases is not whether old equity can participate by contributing new value, but whether *a bankruptcy judge* should be able to *force* creditors to

participate in such a plan by telling them that they have misperceived their own best interests.[13]

Finally, even if pre-bankruptcy equity holders were a significant source of reorganization funding in 1939, when the country was not yet out of the Depression, today's capital markets make it much easier for worthwhile ventures to obtain financing. See Walter J. Blum & Stanley A. Kaplan, *The Absolute Priority Doctrine in Corporate Reorganizations*, 41 U. CHI. L. REV. 651, 672 (1974) ("Current data do not support the belief that old shareholders are a fruitful source of additional funds when the public capital markets are unlikely to provide funds. In recent years shareholders have seldom contributed new capital"). The inability of a reorganized company to convince anyone other than a pre-petition equity holder to lend it money today suggests not a failure of the capital markets as much as a realistic assessment that the reorganization is not likely to succeed.

At bottom, the panel majority's decision is contrary to the principal underlying premise of equity ownership in an enterprise: in exchange for its greater potential for return, equity takes the greater risk of loss. See Basil, *supra*, 101 COM. L.J. at 302-303. It is antithetical to the principles underlying the absolute priority rule to permit a debtor's equity holders, who would have kept all of the profits in the enterprise had there been any, to shift the risk of loss to a senior class of creditors when business turns sour.

CONCLUSION

The petition for a writ of certiorari should be granted.

---

[13] In fact, as Dean Baird has pointed out, the new value exception is a one-way ratchet allowing equity holders first to see whether a judge undervalues the firm and only then to commit themselves to invest in it. BAIRD, THE ELEMENTS OF BANKRUPTCY at 262-263.

Respectfully submitted.

THOMAS S. KIRIAKOS
JAMES C. SCHROEDER
BEVERLEY J. KLEIN
Mayer Brown & Platt
190 South LaSalle St.
Chicago, Illinois 60603
(312) 782-0600

ROY T. ENGLERT, JR.
Counsel of Record
Mayer Brown & Platt
2000 Pennsylvania Ave., N.W.
Washington, D.C. 20006
(202) 463-2000

February 1998

APPENDIX

APPENDIX A

In the
United States Court of Appeals
for the Seventh Circuit

NOS. 96-2137 & 96-2138

IN THE MATTER OF:

203 N. LASALLE STREET PARTNERSHIP,
an Illinois Limited Partnership,

Debtor-Appellee,

APPEAL OF:

BANK OF AMERICA ILLINOIS,

Appellant.

Appeal from the United States District Court for the
Northern District of Illinois, Eastern Division.
Nos. 95 C 7144 & 96 C 238—**Paul E. Plunkett**, *Judge.*

ARGUED NOVEMBER 6, 1996—DECIDED SEPTEMBER 29, 1997

Before CUMMINGS, RIPPLE and KANNE, *Circuit Judges.*

RIPPLE, *Circuit Judge*. This case involves Bank of America Illinois' ("Bank America") appeal of the confirmation of a bankruptcy reorganization plan. 203 N. LaSalle Street Limited Partnership ("LaSalle"), which owns fifteen floors of office space in a Chicago building, failed to pay a secured note held by Bank America, and Bank America attempted to foreclose on the property. LaSalle filed for bankruptcy under Chapter 11, 11 U.S.C. § 1101 *et seq.* LaSalle eventually filed a reorganization plan that the bankruptcy court approved, as modified, despite Bank America's opposition to the plan. The district court upheld the bankruptcy court's order confirming the plan. For the reasons set forth in the following opinion, we affirm the judgment of the district court.

I

BACKGROUND

A. *Facts*

The debtor in this case, LaSalle, is an Illinois limited partnership that owns fifteen floors of office space in a building in the central business district of Chicago. The property was encumbered by a lien in favor of Bank America; LaSalle owed Bank America more than $93 million. LaSalle's loan was secured by a first non-recourse mortgage on the property that came due on January 3, 1995. LaSalle was unable to repay the loan, so Bank America started a foreclosure action in state court on January 20, 1995. In response, LaSalle filed for bankruptcy under Chapter 11. Bank America elected to have its secured claim, which was significantly greater than the value of the security, treated as a secured claim and an unsecured claim under 11 U.S.C.

§ 1111(b).[1] In addition to the debt held by Bank America, LaSalle had several other debts outstanding: One of the general partners held a second non-recourse mortgage on the property; $2.3 million in real estate taxes remained unpaid; and other non-inside creditors held $90,000 in trade claims.[2] In addition to the property, LaSalle held the right to a cash account consisting of pre-petition rents that amounted to $3.1 million. By filing for bankruptcy rather than having Bank America foreclose on the property, LaSalle's partners postpone significant tax liabilities estimated at $20 million.

Before the bankruptcy court, the debtor filed a plan for reorganization on April 13, 1995, which it amended on May 12. Bank America objected to the amended plan, and the bankruptcy court rejected it because, in the court's view, the plan was not feasible. LaSalle further revised the plan and filed another reorganization plan on September 11, 1995. Under the new plan, Bank America was the only party to object, and at least one impaired class of claims, the unsecured trade debt class, voted to approve the plan. The bankruptcy court conducted a hearing and confirmed the plan

---

[1] *See In re Woodbrook Assocs.*, 19 F.3d 312, 317 n.2 (7th Cir. 1994). In a Chapter 11 bankruptcy proceeding, a secured creditor, in most situations, may elect how his claim is treated. Lawrence P. King, Collier on Bankruptcy ¶ 1103[1] (15th rev. ed. 1997). A creditor with a lien on the debtor's property may elect either to continue to have its debt secured by the property in its full amount or to separate its claim in two: a secured claim in the amount of the value of the property and an unsecured claim for the deficiency amount. *See* 11 U.S.C. §§ 506(a), 1111(b). Bank America has chosen this latter course.

[2] LaSalle originally owed $160,000 in unsecured trade debt, but after filing for bankruptcy, the general partners purchased some of the trade claims.

(with slight modification).[3] In its thorough opinion, the bankruptcy court found that the plan met all of the necessary requirements under 11 U.S.C. § 1129. It therefore confirmed the plan, finding the value of the property at that time to be $55.8 million.

Under the confirmed plan, the debtor's partners would contribute new capital: $3 million the day after the effective date of the plan and five annual installments of $625,000 thereafter. LaSalle would pay the non-insider trade creditors in full without interest. Upon confirmation, the insiders would waive their general unsecured claims. The priority and state tax claims under the plan would be paid within 30 days of approval. Bank America's secured claim ($54.5 million)[4] would be paid partly in cash, $1.1 million within 5 days of the effective date of the plan, and the rest as a 7-10 year interest-bearing note secured by the property. Monthly payments would be made on a 30-year amortization schedule, and any excess payments would be applied to the principal. At the end of that time, if the property were sold or refinanced, any additional proceeds, after the secured claim

---

[3] The plan originally called for paying the trade claims 180 days after confirmation of the plan; the bankruptcy court confirmed the plan on the condition that LaSalle also agree to pay interest to the trade creditors on the principal amounts for the 180 days following confirmation.

[4] The bankruptcy reduced the value of the property at the time of confirmation, $55.8 million, by the amount that it would have cost Bank America to dispose of the property, $1.3 million, and arrived at a value of Bank America's secured loan in the amount of $54.5 million. Bank America also has an unsecured claim for the amount of the deficiency, the difference between its secured claim and the total amount that LaSalle owed the bank. Bank America's deficiency claim is for approximately $38.5 million.

is paid, would be applied toward Bank America's unsecured claim, $38.5 million. The plan also provided that, in the case of default, the debtor's deed held in escrow would be conveyed to Bank America.

B. *District Court Proceeding*

Bank America appealed the bankruptcy court's confirmation of LaSalle's reorganization plan to the district court and raised 14 objections. The district court reviewed Bank America's objections and upheld the decision of the bankruptcy court in its entirety. The district court rejected Bank America's objection that the plan was not proposed in good faith, as required by § 1129(a)(3), because that provision focuses on the content and effect of the plan, not the subjective motivation of the plan's proponent. The court further reasoned that, even if § 1129(a)(3) were concerned with the filer's motivation, here the avoidance of tax consequences, LaSalle's proposal was not filed in bad faith. The district court also found that the bankruptcy court's factual findings that the plan was accepted by an actual impaired class, as required by § 1129(a)(10), was not clearly erroneous. The district court agreed with the bankruptcy court that the plan met § 1129(a)(7)(A)'s "best interest" test because, under the proposed plan, Bank America receives property of a value not less than the amount Bank America would receive if the debtor had proceeded under Chapter 7: The present value of the plan for the secured claim is the same under the plan as Bank America would receive in a Chapter 7 liquidation. In addition, Bank America's deficiency claim, its unsecured claim, is treated more favorably under the proposed plan than under Chapter 7 because, under Chapter 7, Bank America would have received nothing for its unsecured deficiency claim. Further, according to the court, because the best interest test is met and the plan is carefully tailored to fulfill the requirements of

that test, the plan does not unfairly discriminate against Bank America. Indeed, said the court, the discrimination from which Bank America claimed to suffer—other unsecured claims are paid off 100%, but Bank America gets only 16% of its unsecured claim—is not unfair. The district court agreed with the bankruptcy court that the Bankruptcy Code did not abolish the Bankruptcy Act's "new value" corollary to the absolute priority rule. In addition, the district court agreed with the bankruptcy court that the requirements for the new value corollary were met in this case. Therefore, the court found, the property held by the partners under the proposed plan did not violate the absolute priority rule. The court also upheld the bankruptcy court's determination that, despite the potential cash shortfalls in years 7 and 8 of the plan, the plan was feasible. Finally, the district court upheld the bankruptcy court's finding that the plan was fair and equitable in its treatment of Bank America's unsecured claim; the plan therefore met § 1129(b)(2)'s "cramdown" requirements. The district court, in short, upheld the bankruptcy court in toto, and Bank America appeals.

II

DISCUSSION

For a reorganization plan to be confirmed, the plan must meet the requirements of 11 U.S.C. § 1129.[5] Bank America

---

[5] Section 1129 provides in relevant part:

(a) The court shall confirm a plan only if all of the following requirements are met:

(1) The plan complies with the applicable provisions of this title.

(continued...)

---

[5] (...continued)

. . . .

(3) The plan has been proposed in good faith and not by any means forbidden by law.

. . . .

(8) With respect to each class of claims or interests—

(A) such class has accepted the plan; or

(B) such class is not impaired under the plan.

. . . .

(10) If a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by an insider.

(11) Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan.

. . . .

(b)(1). . . [I]f all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan . . . if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

(2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

. . . .

(B) With respect to a class of unsecured claims—

. . . .

(ii) the holder of any claim or interest that is junior to the claims of such class will not receive

(continued...)

makes many of the same arguments to us that it did on appeal to the district court. Bank America alleges that the plan should not have been confirmed because it did not meet a number of § 1129's requirements. Success on the merits of any one of these claims would dictate a reversal of the bankruptcy court's confirmation order, unless, as LaSalle maintains, the appeal is moot. We shall deal with each of these issues in turn.

However, before we turn to the specifics of the case, a quick overview of the process for the confirmation of a reorganization plan may prove useful. For a bankruptcy court to approve a proposed reorganization plan, the plan's proponent must show that the plan satisfies the 13 requirements of § 1129(a), if they are applicable. With one exception, to be discussed, a plan must meet all 13 requirements. They are: (1) the plan's compliance with Title 11, (2) the proponent's compliance with Title 11, (3) the good faith proposal of the plan, (4) the disclosure of payments, (5) the identification of management, (6) the regulatory approval of rate changes, if applicable, (7) the "best interest" test, (8) the unanimous acceptance by impaired classes, (9) the treatment of administrative and priority claims, (10) the acceptance by at least one impaired class of claims, (11) the feasibility of the plan, (12) the bankruptcy fees, and (13) retiree benefits. *See* 11 U.S.C. § 1129(a)(l)-(13). If, however, a plan is not approved by all of the impaired classes, as generally required by 11 U.S.C. § 1129(a)(8), it is still possible for a plan to be confirmed. If at least one of the non-insider, impaired classes of claims

---

[5] (...continued)

> or retain under the plan on account of such junior claim or interest any property.

11 U.S.C. § 1129.

approves the plan, then a plan may be confirmed if two additional requirements are met. *See* 11 U.S.C. § 1129(b). If the bankruptcy court finds that all of the applicable requirements of § 1129(a) are met except for § 1129(a)(8), and also that the plan does not discriminate unfairly between impaired classes and is fair and equitable to the rejecting classes, then the court may confirm the plan. *See* 11 U.S.C. § 1129(b)(1)-(2).

In our review of the district court and bankruptcy court decisions, we review both courts' conclusions of law de novo. *In re Chappell*, 984 F.2d 775, 779 (7th Cir.1993). We review the determinations of fact by the bankruptcy court for clear error. *In re Andreuccetti*, 975 F.2d 413, 419-20 (7th Cir. 1992). A "'finding is clearly erroneous when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed.'" *FDIC v. Bierman*, 2 F.3d 1424, 1431 (7th Cir. 1993) (quoting *Anderson v. Bessemer City*, 470 U.S. 564, 573 (1985)) (internal quotation and citation omitted).

A. *Mootness*

As a preliminary matter, we must respond to LaSalle's contention that the appeal should be dismissed as moot. LaSalle submits that, because the reorganization plan has been confirmed and LaSalle has implemented the plan, it would be very difficult now to reverse all the necessary transactions without harming a number of innocent third parties. Specifically, LaSalle contends: Investors have already put their capital into the reorganized debtor (thus foregoing other investment opportunities); LaSalle has renegotiated a lease with one of its two largest tenants; that tenant has spent a significant amount of money to redecorate its leased space; and numerous other payments have been made. In short,

LaSalle concludes, under the circumstances, it would be very difficult for the bankruptcy court to "unscramble the eggs" now.

The mere fact that Bank America was unable to obtain a stay from either the district court or this court does not necessarily lead to the conclusion that, once the plan has been confirmed and implemented, all issues related to the confirmation of the plan are moot. *See In re Envirodyne Indus.*, 29 F.3d 301, 303-04 (7th Cir. 1994); *In re Andreuccetti*, 975 F.2d at 418. In *In re Envirodyne*, we held that a court's ability to provide at least partial relief satisfies the Article III mootness issue. 29 F.3d at 303-04. With respect to the principle that courts will frequently refuse to modify a bankruptcy plan if it has already been implemented (formerly known as the "equitable mootness" doctrine), we noted that our inquiry is "whether modification of the plan of reorganization would bear unduly on the innocent." *Id.* at 304; *cf. In re Lloyd*, 37 F.3d 271, 273 (7th Cir. 1994) (holding in bankruptcy proceeding that, because court could fashion some relief for the debtor, appeal was not moot, despite estate's sale of property to good faith purchaser). "So if modification of a plan of reorganization would upset legitimate expectations, it *may* be refused . . . ." *In re Envirodyne*, 29 F.3d at 304 (emphasis added).

Many of the transactions that have occurred to date easily can be reversed without significant harm to third parties. Bank America seeks to foreclose on the property; doing so would not affect the monies that the trade creditors and state taxing authority have received. Bank America also does not seek to reverse the lease agreement reached between LaSalle and its tenant. Moreover, Bank America has agreed to return any payments and documents to LaSalle necessary to reverse the transaction. Finally, Bank America has consented to repay to the investors their investments plus reasonable

interest. We believe that, if we were to reverse the decisions of the district and bankruptcy courts, the bankruptcy court could fashion some form of relief that would not unduly burden innocent third parties. Therefore we, like the district court, do not agree with LaSalle that the appeal is moot.

B. *Feasibility*

Bank America insists that the plan fails to meet the feasibility requirement of § 1129(a)(11), which requires that, in order for a plan to be confirmed, the "[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization of the debtor . . . ." 11 U.S.C. § 1129(a)(11). In determining that the plan was feasible, the bankruptcy court need not find that it is guaranteed to succeed; "[o]nly a reasonable assurance of commercial viability is required." *In re T-H New Orleans Ltd. Partnership*, 116 F.3d 790, 801 (5th Cir. 1997) (brackets in original); *accord In re Acequia, Inc.*, 787 F.2d 1352, 1364 (9th Cir. 1986); *In re Monnier Bros.*, 755 F.2d 1336, 1341 (8th Cir. 1985). Bank America, in arguing that the plan will not succeed, focuses on years 7 and 8 of the plan. In those years, LaSalle expects that it will experience cashflow shortfalls.

The bankruptcy court scrutinized the plan very carefully and, despite these shortfalls, determined that the plan was feasible. It reasoned that the cashflow under the plan would be sufficient to pay all the debtor's expenses and the debt service to the bank for the first six years of the plan. By that time, the bankruptcy court concluded, LaSalle will have paid down the principal on the note by $7.5 million. In years 7 and 8 of the plan, however, there will be some cashflow shortages because of likely costs expended to renew the lease of one of the major tenants in the property. In years 9 and 10, the court predicted, projected cashflow will again exceed

expenses and debt service. This cashflow shortfall would not make the plan unfeasible, stated the court, because it was likely that, after six years of successful implementation of the plan, Bank America voluntarily would lend the needed capital to LaSalle. If, on the other hand, the bank at that time decided not to lend LaSalle the money, LaSalle could sell its interest in the property and prepay the balance of the loan. The bankruptcy court, after hearing expert testimony on the improving market for office space in Chicago's central business district, determined that, at the time of the cashflow shortfall, the value of LaSalle's property would significantly exceed the remaining principal on the secured debt. Alternatively, the court found that, even if LaSalle did not make up the shortfall, there would not be a liquidation. Under the plan, if Bank America refuses to lend LaSalle the necessary capital and LaSalle does not sell its property, LaSalle will automatically and voluntarily transfer the property to Bank America.

Bank America forwards three points that, it insists, undermine the bankruptcy court's conclusion that the plan is feasible. First, Bank America argues that the success of the plan depends upon the bank's willingness to re-lend money to LaSalle. Second, Bank America contends that, although there was expert testimony on which the court relied about the improving real estate market in the central business market in general, there was no testimony of an improving market for this specific property. Finally, Bank America asserts that the automatic reconveyance of the property to the bank in the event of LaSalle's default does not sufficiently protect Bank America's interest because a potential future bankruptcy proceeding could invalidate the conveyance.

We agree with the district court, which, when considering the same arguments on appeal, concluded that these concerns are "primarily hypothetical, and constitute

merely disagreements with the inferences drawn by the bankruptcy court." *In re 203 N. LaSalle St. Ltd. Partnership*, 195 B.R. 692, 710 (N.D. Ill. 1996). Contrary to Bank America's assertions, the bankruptcy court did not conclude that the success of the plan required Bank America to re-lend LaSalle capital in years 7 and 8 of the plan, although the court concluded that such a transaction would be the most likely outcome. Instead, the court considered alternatives that would not violate the § 1129(a)(11) requirement even if Bank America were not to re-lend capital to LaSalle. We do not think that the bankruptcy court's conclusion on this point is clearly erroneous. We also do not believe that the inference the bankruptcy court drew about the future marketability of LaSalle's property by relying on expert testimony concerning the future real estate market in the property's vicinity, rather than requiring expert predictions with respect to the future market solely for LaSalle's property, was clearly erroneous. A plan need not be assured of success to be confirmed. We cannot accept Bank America's submission that the bankruptcy court's decision on this point was clearly erroneous.

C. *New Value Corollary*

1.

The general rule for a reorganization plan that has not been approved unanimously by the impaired classes is that it must meet the strictures of the absolute priority rule to be approved.[6] The Supreme Court of the United States has

---

[6] The absolute priority rule derives from § 1129's "fair and equitable" requirement. *See In re Snyder*, 967 F.2d 1126, 1128 (7th Cir. 1992) (tracing the absolute priority rule, conceptually, at least as far back as *Northern Pac. Ry. v. Boyd*, 228 U.S. 482

(continued...)

summarized the absolute priority rule as follows: "[A] dissenting class of unsecured creditors must be provided for in full before any junior classes can receive or retain any property under a reorganization plan." *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 202 (1988) (internal quotation and brackets omitted).

Prior to the passage of the Bankruptcy Code, there was a corollary to this rule, the "new value" corollary. *See In re Wabash Valley Power Ass'n*, 72 F.3d 1305, 1314 (7th Cir. 1995), *cert. denied*, 117 S.Ct. 389 (1996). Under the new value corollary, established by *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939), a junior claim holder (an equity interest holder, for example) may retain, in some circumstances, his equity interest in the property over the objection of a senior impaired creditor class. To do so, the junior interest holder, under the proposed plan, must contribute new capital to the restructured enterprise. That capital must be new, substantial, necessary for the success of the plan, reasonably equivalent to the value retained, and in the form of money or money's worth. *In re Woodbrook Assocs.*, 19 F.3d 312, 319-20 (7th Cir. 1994). The Supreme Court has noted that this corollary is rooted in the pragmatic realization that, in the course of a reorganization, "additional funds will be essential to the success of the undertaking, and it may be impossible to obtain them, unless stockholders are permitted to contribute and retain an interest sufficiently valuable to move them." *Kansas City Terminal Ry. v. Central Union Trust Co.*, 271 U.S. 445, 455 (1926).

---

[6] (...continued)
(1913)); King, Collier on Bankruptcy ¶ 1129.04, at 1129-82 (tracing the rule back to *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106 (1939)).

In enacting the Code, Congress codified the absolute priority rule, § 1129(b)(2)(B)(ii), by providing that a plan's treatment of the creditors would be fair and equitable if

> the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan *on account of* such junior claim or interest any property.

11 U.S.C. § 1129(b)(2)(B)(ii) (emphasis added). At the same time, the Code altered the scheme of plan confirmation to provide that a plan could be confirmed if at least one of the impaired non-insider classes of creditors votes to approve the plan. The court then must confirm the plan if it finds that the plan does not discriminate unfairly and is "fair and equitable" to each dissenting class. *See* 11 U.S.C. § 1129(b)(2).

At the time it codified the absolute priority rule, Congress did not explicitly codify the new value corollary. *In re Woodbrook*, 19 F.3d at 320. Neither we nor the Supreme Court has had occasion to determine definitively whether this new value exception survived passage of the Bankruptcy Code. *See In re Wabash*, 72 F.3d at 1315.[7]

---

[7] Although the question of whether the new value corollary survived Congress' passage of the Bankruptcy Code has not been determined definitively in this circuit, we have considered it on several occasions without deciding the issue. *See, e.g., In re Wabash; In re Woodbrook; In re Snyder*, 967 F.2d 1126, 1130 (7th Cir. 1992); *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351 (7th Cir. 1990); *In re Stegall*, 865 F.2d 140 (7th Cir. 1989). Our previous opinions have provided conflicting, albeit tentative, suggestions on the directions that we might take. We have intimated on occasion that the passage of the Bankruptcy Code has left the new value corollary intact. *See In re*
(continued...)

Both the bankruptcy court and the district court concluded that the new value corollary did survive passage of the Code. Based upon its conclusion, the bankruptcy court determined that LaSalle's plan did not violate § 1129(b)(2)'s absolute priority rule because LaSalle's plan met the requirements of the new value corollary. Bank America contends that the courts erred on both counts: First, the new value exception is no longer viable; second, even if still valid, LaSalle's plan did not meet the requirements of the exception.

---

[7] (...continued)
Woodbrook, 19 F.3d at 320 ("The current trend is to treat the new value precept not as an exception (as it was commonly called) but as a corollary to the absolute priority rule preserved in the 1978 Code."); *In re Snyder*, 967 F.2d at 1129 (concluding after significant discussion that "[t]here is nothing in either the text or the legislative history of § 1129(b) that can be said to demonstrate a clear intent to modify seventy-five years of judicial construction of the absolute priority doctrine or its new value exception"); *cf. In re Potter Material Serv., Inc.*, 781 F.2d 99, 101-04 (7th Cir. 1986) (applying new value corollary without discussion of whether exception survived the Code). *But see In re Stegall*, 865 F.2d 140, 142 (7th Cir. 1989) (noting that question was open, despite *In re Potter*). On the other hand, we have indicated that the new value exception might have been abolished by the codification of the absolute priority rule without also incorporating the new value exception. Such a course would result in a holding that the absolute priority rule is absolute: There is no new value exception after the passage of the Bankruptcy Code. *See Kham & Nate's Shoes*, 908 F.2d at 1360-61 (characterizing the new value exception as judicial dicta and noting that the language of the Code and legislative history suggest that the exception vanished in 1978). We note that the panel in *Kham & Nate's Shoes* did not have the benefit of the Supreme Court of the United States' opinion in *Dewsnup v. Timm*, 502 U.S. 410 (1992). As we explain below, *Dewsnup* is instructive on this issue.

We begin, as we must with every statutory interpretation question, with the wording of the statute. Bank America reads § 1129(b)(2)(B)(ii) to require, by the very force of the language itself, the repeal of the new value corollary. As we have noted earlier, this statutory provision provides that a junior interest may not receive any property in a reorganization "on account of" its previous interest before an objecting impaired senior creditor is paid in full. Under this reading of the statute, Bank America contends that, even assuming that LaSalle's reorganization plan meets the requirements of the new value exception, confirmation of the plan violates the statutory language. LaSalle's old equity interest holders, whose claims are junior to those of Bank America, are receiving or retaining property, the ability to continue to run their business, "on account of" their old equity interest.

This interpretation requires, of course, that the phrase "on account of" bear a great deal of weight. As a matter of abstract logic, and certainly of semantics, one can argue that such a meaning can be attributed to these three words. At some level of abstraction, the new investors in the plan can be said to have the opportunity to invest and to control the company "on account of" their previous relationship with the debtor. However, the phrase is also susceptible of another construction. Congress, in using the "on account of" language, might well have intended a more direct causation between the property received by the debtor and the old equity interest. It can be cogently reasoned that, when an old equity holder retains an equity interest in the reorganized debtor by meeting the requirements of the new value corollary, he is not receiving or retaining that interest "on account of" his prior equitable ownership of the debtor. Rather, he is allowed to participate in the reorganized entity "on account of" a new, substantial, necessary and fair infusion of capital.

The mere recitation of the possible interpretations of the statutory absolute priority rule, interpretations argued and reargued in both the cases and the academic literature,[8]

---

[8] The district and bankruptcy courts are quite divided over this issue, but a majority of such courts have concluded that the new value corollary survived the passage of the Bankruptcy Code. *See* J. Ronald Trot, Joel G. Samuels & Kevin T. Lantry, "Survey of the New Value Exception to the Absolute Priority Rule and the Preliminary Problem of Classification," CA46 ALI-ABA 479, 540-43 (1995) (surveying 88 published district court and bankruptcy court decisions, issued after the Supreme Court's decision in *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197 (1988), and involving the new value corollary, and stating that, of these, 73% (64 cases) explicitly or implicitly found the new value corollary survived passage of the Bankruptcy Code, 11% (10 cases) determined that it did not, and 16% (14 cases) did not resolve the issue); *see also, e.g., BT/SAP Pool C Assocs. v. Coltex Loop Central Three Partners*, 203 B.R. 527, 534 (S.D.N.Y. 1996) (new value corollary survived codification of absolute priority rule); *In re Way Apartments, D.T.*, 201 B.R. 444, 455 (N.D. Tex. 1996) (same); *In re Sea Garden Motel & Apartments*, 195 B.R. 294, 301 (D.N.J. 1996) (noting that most courts have recognized the continued existence of the new value corollary); *In re Elmwood, Inc.*, 182 B.R. 845, 852-53 (D. Nev. 1995) (applying new value corollary). Academics and commentators, too, have not agreed on the issue. *See, e.g.*, Edward S. Adams, "Toward a New Conceptualization of the Absolute Priority Rule and its New Value Exception," 1993 Det. C.L. Rev. 1445 (concluding that corollary is still viable); Bruce A. Markell, "Owners, Auctions, and Absolute Priority in Bankruptcy Proceedings," 44 Stan. L. Rev. 69 (1991) (same); Jarlon Tsang, Note, 14 Ann. Rev. Banking L. 361 (1995) (same); Clifford S. Harris, Note, 89 Mich. L. Rev. 2301 (1991) (same); Michael H. Strub, "New Value Rule: Applying the Single-Asset Paradigm," 111 Banking L.J. 228 (1994) (concluding pre-Code practice not viable); John D. Ayer, "Rethinking Absolute

(continued...)

evidence the ambiguity of the provision. *See Dewsnup v. Timm*, 502 U.S. 410, 416 (1992) (noting that the contrasting positions of the parties with respect to section 506 and its relationship to other parts of the Code "do embrace some ambiguities"). We therefore must look beyond the statutory language.

The Supreme Court has made it clear that, in interpreting the Bankruptcy Code, we must keep in mind that "[w]hen Congress amends the bankruptcy laws, it does not write 'on a clean slate.'" *Dewsnup*, 502 U.S. at 419 (quoting *In re John M. Russell, Inc. (Emil v. Hanley)*, 318 U.S. 515, 521 (1943)). The Court has been "reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history." *Id.* (citing *United Savs. Ass'n v. Timbers of Inwood Forrest Associates*, 484 U.S. 365 (1988)). As we have noted, for more than fifty years, the new value precept has been recognized as an important corollary or exception to the absolute priority rule. *See In re Snyder*, 967 F.2d 1126, 1128 (7th Cir. 1992). "'[I]f Congress intends for legislation to change the interpretation of a judicially created concept, it makes that intent specific. The Court has followed this rule with particular care in construing the scope of bankruptcy codifications.'" *In re Snyder*, 967 F.2d at 1129 (quoting *Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Protection*, 474 U.S. 494, 501

---

[8] (...continued)
Priority after *Ahlers*," 87 Mich. L. Rev. 963 (1989) (same); Julie L. Friedberg, Comment, 66 Temp. L. Rev. 893 (1993) (same); Salvatore G. Gangemi & Stephen Bordanaro, Note, "The New Value Exception: Square Peg in a Round Hole," Am. Bankr. Inst. L. Rev. 173 (1993) (same).

(1986)) (brackets in original). In short, the Supreme Court has told us that we are not to abandon past bankruptcy practices absent a clear indication that Congress intended to break from those practices. "We will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure." *Pennsylvania Dep't Pub. Welfare v. Davenport*, 495 U.S. 552, 563 (1990).

In this case, there can be no question that "Congress must have enacted the Code with a full understanding" of the absolute priority rule and its new value corollary. *Dewsnup*, 502 U.S. at 419. As this court has detailed on a prior occasion, *see In re Snyder*, 967 F.2d 1126, 1129 (7th Cir. 1992), the new value corollary has long been ensconced in our bankruptcy practice. Indeed, it has been noted in several Supreme Court cases.[9] There was even a proposal before Congress to expand the scope of the new value corollary by eliminating the requirement that the new capital to be provided be in money or money's worth.[10] Yet, despite its awareness of the major role that the new value exception traditionally has played in the bankruptcy field, Congress never explicitly declared, either in the text or in the

---

[9] *See, e.g., Mason v. Paradise Irrigation Dist.*, 326 U.S. 536, 541-42 (1946); *Marine Harbor Properties v. Manufacturer's Trust Co.*, 317 U.S. 78, 86 (1942); *Case v. Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 121 (1939).

[10] *See In re Snyder*, 967 F.2d at 1130 (discussing the Bankruptcy Commission proposal). The proposal was rejected. Because the proposal sought to expand the scope of the new value corollary, Congress' rejection of the proposal hardly supports the view that Congress intended to abolish the entire new value exception. The existence of the proposal assures us of Congress' awareness of the exception.

legislative history of the statute, that it intended the abolition of this important tool.

Of the two textual interpretations, we think that the far more plausible is the one that interprets the "on account of" language to permit the continued existence of the new value corollary. We think that it is more reasonable to believe that Congress legislated on the understanding that, in new value transactions, old equity owners receive stock in exchange for the additional capital they invest. This interpretation is far more reasonable in terms of the practical realities of bankruptcy administration than the highly conceptualistic suggestion that the opportunity to participate in the reorganization is itself property retained on account of an old equity holder's prior ownership interest. As a practical matter, the opportunity to participate in a reorganization plan, even an exclusive right, is not retained on account of an old equity holder's former ownership interest; the opportunity to give new value and to have the opportunity to receive a return on that capital infusion is given because such participation, even exclusive participation, may enhance the value of the business after reorganization. Indeed, exclusivity may be necessary simply because it may be easier to obtain additional funding from the old equity participants.

The new value corollary has been a major source of new funding in reorganizations for the past fifty years. To assume that Congress abolished this device implicitly by the three words "on account of" is to assume that Congress made a major economic decision affecting the economic health, and indeed the continued existence, of many corporate entities without ever addressing squarely the issue in the statute or its legislative history. The Code does provide some flexibility in plan confirmation in the face of dissenting creditors by denying minority dissenting creditors the right to prevent confirmation as long as the requisite majority of the creditors

in each class accepts the plan. To the extent that the new value corollary was, in pre-Code days, a device that gave the plan proponent some leverage in dealing with minority creditors, its necessity may not be as great today as it was in an earlier period.[11] Nevertheless, the new value corollary still serves as a significant source of new funding for the ailing entity,[12] and one would expect that Congress would address deliberately such a significant issue of economic policy if it had determined to abolish it. Notably, Congress gave not one hint, in the text of the statute or its legislative history, that it viewed the new measures regarding the participation of creditors in the approval of the plan to be connected to the continued availability, or the demise, of the new value corollary.

To declare the abolition of the new value corollary would require us to take one of several paths, all of which would be inconsistent with the directions of the Supreme Court of the United States. We could hold that the statutory version of the absolute priority rule is unambiguous in its rejection of the new value corollary and disregard the great body of judicial opinions and serious scholarship that has contended for a

---

[11] There are differing views about the effectiveness of the Code's attempt to give the proponents of the plan some flexibility in this regard. The confirmation standard contained in section 1129 still allows slightly more than one third of a class of creditors to veto a plan accepted by every other party to the reorganization and permits a large investor who owns an entire class of securities to thwart any confirmation plan involving shareholder participation.

[12] During times of financial instability, banks often restrict the number of outstanding loans. The resulting "credit crunch" affects the ability of businesses to obtain the capital that they need. During such a period, shareholders might represent the only source of financing for the reorganization of an entity in reorganization.

variety of interpretations. Alternatively, we could acknowledge the provision's ambiguity but disregard the clear direction of the Supreme Court that we are not lightly to infer that Congress has altered by implication established bankruptcy practice. Rather than embark on either of these precarious routes, we shall join the other circuits[13] that have decided the issue and hold that the new value corollary remains a part of our bankruptcy jurisprudence.

---

[13] The Ninth Circuit has concluded that the new value exception is alive and well. *In re Bonner Mall Partnership*, 2 F.3d 899, 907 (9th Cir. 1993), *cert. granted*, 510 U.S. 1039, *case dismissed*, 513 U.S. 18 (1994) (case dismissed as moot after parties reached settlement). The Sixth Circuit also has adopted the position that, even after the enactment of the Code, the new value corollary has vitality. *See In re U.S. Truck Co.*, 800 F.2d 581, 588 (6th Cir. 1986) ("If McKinlay were retaining an interest without contributing any capital, the plan would clearly violate the Code . . . . But McKinlay is giving up its prior interest and participating in the reorganized company by making a [capital] contribution."). The Fifth Circuit, in *In re Greystone III Joint Venture*, 995 F.2d 1274 (5th Cir. 1991), *cert. denied*, 506 U.S. 821 (1992), analyzed the issue quite carefully and concluded that the exception did not survive the Code's enactment. However, after the Supreme Court's decision in *Dewsnup v. Timm*, 502 U.S. 410 (1992), the court on rehearing rescinded the portion of the opinion deciding the issue instead of evaluating how that decision would affect the case before the court. The Fourth Circuit, in *In re Bryson Properties XVIII*, 961 F.2d 496 (4th Cir.), *cert. denied*, 506 U.S. 866 (1992), struggled with the issue and, after noting that neither the underlying policy reasons nor the legislative history leads to a clear answer, concluded that, in the case before it, the proposed plan, which included a provision by which the old equity holders' new capital contributions would be returned prior to the creditors' unsecured claim, could not be confirmed because the old equity holders retained property on account of their prior interests.

2.

Bank America further submits that, even if a new value exception were to exist under the Code, the debtor's plan here did not meet its requirements because the amount of capital infused was not substantial. The bankruptcy court found that the plan proposed infusing new capital into the reorganized debtor. The new capital, the court determined, amounted to a present-value money equivalent of $4.1 million. The bankruptcy court also concluded that this capital was necessary for the success of the plan, was in money or money's worth, was reasonably equivalent to the interest retained, and was substantial. Thus, according to the bankruptcy court, the plan met the requirements of the new value corollary and did not violate the absolute priority rule.

We review these findings by the bankruptcy court for clear error. *In re Andreuccetti*, 975 F.2d 413, 419-20 (7th Cir. 1993). "Whether the infusion of new capital is 'substantial' is more a common sense determination than a mathematical calculation when the debtor comprises only a single real estate asset which is fully encumbered." *In re Woodbrook*, 19 F.3d 312, 320 (7th Cir. 1994); *accord In re Snyder*, 967 F.2d 1126, 1131-32 (7th Cir. 1992) ("There is no mathematical formula for resolving the substantiality issue, and it will depend on the circumstances of the individual case."). However, "[c]ontributions that are merely nominal, or gratuitous, token cash infusions" will not suffice to meet this requirement. *Id.* at 1131 (internal quotation and citations omitted). In evaluating whether an infusion is substantial in a particular case, courts are to look at the infusion to determine whether it is real and necessary to the successful implementation of the plan. *See In re Woodbrook*, 19 F.3d at 320.

In this case, under the proposed plan, the investors would infuse $6.125 million into the reorganized debtor to make the reorganization plan work. This capital, the bankruptcy court determined, had a present value of over $4 million. The bankruptcy court, in finding that the amount to be infused was substantial, stated:

> Here, the new value being contributed by the partners is substantial both in absolute terms and in its impact in this case. The $4.1 million minimum value of the contribution in this case dwarfs the $30,000 involved in *Snyder* and the $100,000 in *Woodbrook* . . . . The new value contributions proposed by the September 11 plan are not mere tokens, but genuine contributions to the proposed plan.

In re 203 N. LaSalle St. Ltd. Partnership, 190 B.R. 567, 588 (Bankr. N.D. Ill. 1995). The court also noted that, as a percentage of Bank America's unsecured debt, the contribution amounted to 10.7% of that amount. *Cf. In re Woodbrook*, 19 F.3d at 320 (rejecting invocation of new value corollary when contribution was at most 3.8% of unsecured debt); *In re Snyder*, 967 F.2d at 1131 (rejecting invocation of new value corollary when contribution was 2.7% of unsecured claims). We are not firmly convinced that the bankruptcy court made an error in its determination that this amount, in absolute terms and when viewed as a percentage of Bank America's unsecured claim, was substantial. In addition, the bankruptcy court, in evaluating the feasibility of the plan, found that the infusion of new capital was necessary for the successful implementation of the plan. We have fully discussed this determination and concluded that the bankruptcy court did not clearly err in its finding. We similarly believe that the court's ancillary conclusion that the new infusion was necessary to the success of the plan is adequately supported. We therefore hold that, given our

deferential standards, the court did not clearly err in finding that the new value contributed under the plan is substantial. As such, we shall uphold the bankruptcy court's conclusion that the requirements for the new value corollary have been met.

D. *Impaired Class*

Bank America maintains that the acceptance by the impaired class in this case does not meet the Bankruptcy Code's requirement that, when not all of the impaired classes agree to a proposed plan, at least one impaired class that is not an insider class vote to accept the plan. Bank America submits that the impaired class which approved the reorganization plan, here the trade claims, is an artificially impaired class of claims. Bank America, relying on *In re Windsor on the River Associates*, 7 F.3d 127 (8th Cir. 1993),[14] argues that the reason LaSalle did not pay the trade claims in full under the plan was to create an impaired class that would likely vote in favor of the reorganization claim.[15] Both the bankruptcy and district courts rejected this argument.

---

[14] In *In re Windsor*, the Eighth Circuit held that, "for purposes of 11 U.S.C. § 1129(a)(10), a claim is not impaired if the alteration of rights in question arises solely from the debtor's exercise of discretion . . . . Whether Debtor manipulated the terms of its plan for purposes of securing confirmation is a question of fact." 7 F.3d at 132.

[15] Because the plan was confirmed over Bank America's objections, in addition to meeting the other requirements of § 1129, the plan had to meet the "cramdown" requirements as well. "'Cramdown' is the procedure for approving a reorganization plan in the face of creditor resistance. It requires that at least one class of impaired creditors approve the plan . . . ." *In re Wabash Valley Power Ass'n*, 72 F.3d 1305, 1313 (7th Cir. 1995).

The bankruptcy court found, and Bank America does not dispute, that the trade claims are impaired. Under the plan, the trade creditors will not receive the interest due to them on their claims. This is definitely an impairment under the Code. *See In re Wabash Valley Power Ass'n*, 72 F.3d 1305, 1321 (7th Cir. 1995) (stating that "any alteration of the rights constitutes impairment") (internal quotation and citation omitted). The bankruptcy court further found that the plan was proposed in good faith and that it was necessary, given the total funds that LaSalle had on hand, for the plan to impair some unsecured claims. The court therefore concluded that it did not violate the requirements of the Code for LaSalle to impair the trade claims, even though LaSalle had enough capital that it could have paid these claims in full, so that it would have more money available for reorganization and payment for the bank's claims. The district court concluded that the bankruptcy court's finding that the trade debt class was legitimately impaired was not clearly erroneous.

Although we have never before adopted the Eighth Circuit's "artificial impairment" test, we believe that, even assuming that the Eighth Circuit's interpretation of § 1129(a)(10) is the appropriate standard, the bankruptcy court did not err in its application here. We have noted, in discussing *In re Windsor*, that "[a] finding of 'artificial impairment' requires an inquiry into the purposes of the debtor." *In re Wabash*, 72 F.3d at 1321 n.10. *In re Windsor* recognizes that the question of motivation is one for the bankruptcy court, whose resolution of the question is entitled to deference. 7 F.3d at 132. The bankruptcy court found that there were legitimate reasons for impairing the trade claims class. Impairing these claims allowed more money to be dedicated to the successful reorganization of the debtor. The court distinguished this situation from the one at issue in *In re Windsor* in which the only impairment was to wait 60 days

to pay the "artificially impaired" class in full, and the debtor's only purpose for doing so, according to the Eighth Circuit, was to create an impaired class to approve the plan. In short, the bankruptcy court explicitly found that there was no lack of good faith by LaSalle's failure to pay the trade claims in full. We are not left with the definite and firm conviction that the bankruptcy court has made a mistake with respect to this issue.

E. *Other Issues*

Bank America presses several other claims on appeal, but they need not detain us long. First, Bank America claims that the bankruptcy court clearly erred when it found that the plan subjected its unsecured claim to unfair discrimination. The bankruptcy court agreed with Bank America that the plan discriminated between the unsecured trade claims and Bank America's unsecured deficiency claim. The court, however, disagreed that the discrimination was unfair; indeed, the bankruptcy court found that any discrimination between these claims' treatment under the plan redounds to the benefit of Bank America.

Section 1129(b)(1), which applies to the cramdown confirmation of reorganization plans, provides that a plan may be confirmed only if "the plan does not discriminate unfairly . . . . with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." 11 U.S.C. § 1129(b)(l). No one contends that the confirmed plan does not discriminate between classes. Under the plan, the unsecured trade creditors would receive 100% of their claims, except for the interest thereon, and Bank America, according to the court, would receive only 16% of its unsecured deficiency under the plan. However, the bankruptcy court found that this discrimination was not unfair because there was a legally acceptable rationale to support

this disparity. Under § 1129(a)(7), the "best interest" test, for a cramdown proposal to be confirmed, each of the creditors in the Chapter 11 reorganization must receive at least as much as they would under a Chapter 7 liquidation. Under such a liquidation, the trade creditors would have been paid in full; whereas, because the unsecured deficiency claim is a statutory creation of Chapter 11, Bank America would not have received anything for the deficiency amount. Consequently, the bankruptcy court reasoned, the disparity between these claims, with the trade creditors receiving 100% and Bank America receiving 16%, is not unfair. Bank America does better than it would have under Chapter 7, and the trade creditors do no worse. Additionally, the plan called for the payment of the bank's unsecured deficiency claim before any insider creditor would be paid. Finally, the bankruptcy court concluded that this discrimination is narrowly tailored to meet the requirements of the "best interest" test. We believe that this explanation adequately explains the difference in treatment between the two classes of unsecured claims, and the bankruptcy court did not clearly err in refusing to find this discrimination unfair.

Second, Bank America contends that, because the primary subjective purpose of the investors in the reorganized debtor is to stave off the tax liability they would incur if the bank were to foreclose, the plan was not proposed in good faith. To be confirmed, a plan must be "proposed in good faith and not by any means forbidden by law." 11 U.S.C. § 1129(a)(3). "Though the term 'good faith,' as used in section 1129(a)(3), is not defined in the Bankruptcy Code, . . . the term is generally interpreted to mean that there exists 'a reasonable likelihood that the plan will achieve a result consistent with the objectives and purposes of the Bankruptcy Code.'" *In re Madison Hotel Assocs.*, 749 F.2d 410, 424-25 (7th Cir. 1984) (citations omitted). "According to the good faith requirement of section 1129(a)(3), the court looks to the

debtor's plan and determines, in light of the particular facts and circumstances, whether the plan will fairly achieve a result consistent with the Bankruptcy Code." *Id.* at 425. We begin our inquiry by noting that the bankruptcy court's finding that the plan was proposed in good faith is a finding of fact to which we owe deference. *See In re Andreuccetti*, 975 F.2d 413, 420 (7th Cir. 1992). The primary evidence to the contrary that Bank America provides is that the purpose for the reorganization is a desire by the investors to avoid a significant tax liability.[16] This, in and of itself, is insufficient to establish that the bankruptcy court clearly erred because the desire to avoid significant tax liabilities, if legal, is a result consistent with the Bankruptcy Code. *See In re James Wilson Assocs.*, 965 F.2d 160, 170 (7th Cir. 1992) ("It is not bad faith to seek to gain an advantage from declaring bankruptcy—why else would one declare it?"). Bank America also posits that the plan was not proposed in good faith because the risk of the plan falls squarely on Bank America. The bankruptcy court, however, found otherwise. Much of the risk of the plan falls on the shoulders of the new investors. Moreover, Bank America, by focusing on the tax consequences to the plan's investors, appears to be urging that we look at the subjective motivations of those proposing the plan. *In re Madison*'s teachings are to the contrary. The bankruptcy court cataloged the objective benefits and likely

---

[16] Bank America also asserts that the only purpose of the reorganization plan is to "stave off the evil day when the creditors take control of [the debtor's] property." *In re James Wilson Assocs.*, 965 F.2d 160, 170 (7th Cir. 1992). According to Bank America, under *In re James Wilson*, such a plan is a clear case of bad faith. However, unlike the situation contemplated in *In re James Wilson*, LaSalle did not "enter[ ] Chapter 11 knowing that there [was] no chance to reorganize [its] business." *Id.* Rather, two courts have already ruled that LaSalle is able to reorganize its business.

results of the plan, and these are not inconsistent with the Code. We therefore hold that the bankruptcy court did not clearly err when it determined that the plan it confirmed was proposed in good faith.

Finally, Bank America asks that, if we reverse the district and bankruptcy courts' holdings on any issue, we also reverse the bankruptcy court's orders denying (1) relief from the automatic stay and (2) Bank America's request to convert or dismiss the case. Because we uphold the district court's judgment in its entirety, we deny Bank America's request.

Conclusion

For the foregoing reasons, we affirm the judgment of the district court.

AFFIRMED

KANNE, *Circuit Judge*, dissenting. Although I agree with the way the majority opinion handles many of the issues in this case, I must dissent because the plain language of the absolute priority rule, *see* 11 U.S.C. § 1129(b)(2)(B)(ii), does not include a new value exception. Moreover, even if one strains and finds ambiguity in the language of the statute, thus necessitating a look at pre-Code practice, *see Dewsnup v. Timm*, 502 U.S. 410 (1992), the shaky foundation of the pre-Code new value exception coupled with the massive changes in bankruptcy procedures brought on by the Bankruptcy Code demonstrate that Congress did not intend to insert a new value exception into § 1129(b)(2)(B)(ii).

I. PLAIN LANGUAGE

A reorganization plan must be "fair and equitable" to be implemented over the objection of an impaired class of creditors. The absolute priority rule helps define what is "fair and equitable" under a reorganization plan. *See* 11 U.S.C. § 1129(b)(2). A "fair and equitable" plan meets one of two requirements: (1) a class of unsecured creditors must receive property equal to the value of its claim on the effective date of the plan, *see* § 1129(b)(2)(B)(i), or (2) a dissenting class of unsecured creditors must be fully provided for before any junior class can receive or retain property under the plan, *see* § 1129(b)(2)(B)(ii) ("the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property"). In this case, the reorganization plan (the "Plan") does not satisfy the first prong because Bank America will not receive property equal to the value of its $38.5 million deficiency claim on the effective date of the Plan. The Plan also does not satisfy the second requirement—the absolute priority rule—because it permits LaSalle's partners, whose interests are junior to those of Bank America, to "receive or retain" property—*i.e.*, the

exclusive right to retain their equity interests[1] — "on account of" their junior equity interests.

The majority maintains that LaSalle's partners do not retain a property interest "on account of" their prior equity interest, but rather "'on account of' a new, substantial, necessary and fair infusion of capital." *Ante*, at 17. The majority nonetheless admits, as it must, that "the new investors in the plan can be said to have the opportunity to invest and to control the company 'on account of' their previous relationship with the debtor." *Ante*, at 16; *see also In re Bonner Mall Partnership*, 2 F.3d 899, 909 (9th Cir. 1993) ("[I]n some larger sense the reason that former owners receive new equity interests in reorganized ventures is that they are former owners."), *motion to vacate denied and cert. dismissed as moot*, 513 U.S. 18 (1994). Despite this concession, the majority asserts that only "[a]s a matter of abstract logic, and . . . of semantics," one can argue that LaSalle's partners retained property "on account of" their prior interests, and it further surmises that Congress "might

---

[1] A debtor's *exclusive right* to receive or retain an equity interest is property for purposes of the new value exception and the absolute priority rule. *See Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 207-08 (1988) ("Even where debts far exceed the current value of assets, a debtor who retains his equity interest in the enterprise retains 'property.'"); *In re Bryson Properties, XVIII*, 961 F.2d 496, 504 (4th Cir. 1992) ("This exclusive right to contribute constitutes 'property' under § 1129(b)(2)(B)(ii), which was received or retained on account of a prior interest."); *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1360 (7th Cir. 1990) ("An option to purchase stock also is 'property.'"); *see also Ahlers*, 485 U.S. at 208 ("[W]hile the Code itself does not define what 'property' means as the term is used in § 1129(b), the relevant legislative history suggests that Congress' meaning was quite broad.").

well have intended a more direct causation between the property received by the debtor and the old equity interest." *Ante*, at 16-17; *see also Bonner Mall*, 2 F.3d at 909 (noting that "[c]ausation for any event has many and varied levels" and asserting that Congress surely intended a more "direct or immediate causation"). The majority instead believes that the statute implicitly incorporates a "new value corollary" that permits prior interest holders to retain their interests by infusing new capital into the indebted property. The plain language of § 1129(b)(2)(B)(ii), however, fails to even hint at such a corollary or exception. Indeed, this position not only belittles the straightforward language of § 1129(b)(2)(B)(ii) but also ignores the application of that language to the facts of this case.

The Plan permits LaSalle's partners to retain their equity interests "on account of" two separate factors. LaSalle and the majority opinion correctly assert that LaSalle's partners retain their ownership interests "on account of" their new capital contributions. One cannot contest the fact that the partners' new capital contributions are one reason why they are able to maintain their ownership of the indebted property. LaSalle's partners, however, receive this *exclusive* ownership right *only* "on account of" their unique status as prior equity holders. The Plan's grant of this *exclusive* right to LaSalle's partners thus provides a *necessary* element that causes the prior equity holders to retain their junior interests before the satisfaction of Bank America's deficiency claim. "Abstract logic" and "semantics" do not suggest this conclusion—the requirements of the Plan and the language of the statute mandate it.

The motivations of LaSalle's partners magnify this point. They put new capital into the indebted property only so they could postpone the tax losses that they would incur in a foreclosure. In other words, regardless of the new capital

contributions provided by LaSalle's partners, the presence of (and the potential tax liability inherent in) the partners' prior equity interests motivated the Plan's inclusion of the partners' exclusive right to retain their equity interests. The most natural and literal reading of this statute, when applied to the facts of this case, leads one to the inescapable conclusion that LaSalle's partners are retaining their equity interests "on account of" their junior interests in the property.

The Fourth Circuit, in *In re Bryson Properties, XVIII*, 961 F.2d 496 (4th Cir. 1992), adopted this very reasoning in rejecting a debtor's request for application of the new value exception. *Id.* at 504. *Bryson* refused to approve a reorganization plan that gave prior equity holders the *exclusive right* to "'buy' the [indebted] property without exposing it to the market or otherwise allowing any other party . . . the opportunity to bid." *Id.* Although the Fourth Circuit did not explicitly hold in so many words that § 1129 does not include a new value exception or corollary, the outcome of the case reveals a strong devotion to the straightforward language of § 1129(b)(2)(B)(ii) and an implicit rejection of the new value exception.[2]

---

[2] Contrary to the majority's suggestion that the courts of appeals that have addressed this issue have all ruled that the new value exception did survive the enactment of the Bankruptcy Code, *see ante*, at 22 & n.13, *Bryson*'s outcome and analysis reveal that the circuits are not in agreement on the issue. The Ninth Circuit has conducted perhaps the most exhaustive discussion of the issue to date, and it determined that the new value exception remains viable. *See Bonner Mall*, 2 F.3d at 899. The Sixth Circuit also recognized, without discussion, the existence of the new value exception. *See In re U.S. Truck Co.*, 800 F.2d 581, 588 (6th Cir. 1986). A Fifth Circuit panel, however, originally concluded that the new value exception did not survive the enactment of the Code, see

(continued...)

The majority's reading of the statute effectively inserts the words "solely or primarily" before "on account of": "*the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan* ***SOLELY or PRIMARILY*** *on account of such junior claim or interest any property.*" The majority, in other words, qualifies the text of § 1129, and thus permits a departure from an otherwise firm rule that a bankruptcy entity's assets should be assigned by absolute priority. Perhaps the majority's reasoning is driven by the fear that a "but for" interpretation would prevent old equity from ever participating in a reorganized entity—something Congress could never have intended. Indeed, such a result would border on the absurd, but a simpler, "but for" causation requirement would not preclude junior interests from participating in a reorganized entity. If prior equity holders earn their shares in an open auction, for example, their received interests would not be "on account of" their junior interests but "on account of" their capital contributions. *See In re Greystone III Joint Venture*, 995 F.2d 1274, 1283 (5th Cir. 1991), *withdrawn on rehearing* (1992) (Judge Jones dissented from the withdrawal of Part IV, which discusses the new value exception); *Bryson*, 961 F.2d at 504; *In re Outlook/Century Ltd.*, 127 B.R. 650, 654 n.4 (Bankr. N.D. Cal. 1991).

Moreover, the majority opinion fails to consider how its interpretation of the words of "on account of" in

---

[2] (...continued)
In re Greystone III Joint Venture, 995 F.2d 1274, 1281-84 (5th Cir. 1991), *withdrawn on rehearing* (1992); two members of that panel later voted to withdraw the part of the opinion that dealt with the new value exception, apparently in response to *Dewsnup*. *Id.* at 1284-85 (Judge Jones dissented from the removal of the new value exception analysis.).

§ 1129(b)(2)(B)(ii) compares to the use of those same words in other parts of the same section. Section 1129(b)(2)(B)(i), for example, provides that a plan is fair and equitable with respect to a class of unsecured claims if "the plan provides that each holder of a claim of such class receive or retain *on account of* such claim property of a value . . . equal to the allowed amount of such claim." 11 U.S.C. § 1129(b)(2)(B)(i) (emphasis added). In this subsection, "on account of such claim" takes a simple, ordinary "but for" or "because of" meaning. In other words, § 1129(b)(2)(B)(i) provides that a plan is fair and equitable with regard to an impaired, unsecured claim if the holder of an unsecured claim receives a value equal to *that particular unsecured claim*. It would unduly complicate the statute, and indeed make no sense, to insert "primarily or solely" before "on account of such claim" in subsection § 1129(b)(2)(B)(i). Congress surely could not have intended such a meaning for that subsection. Nonetheless, the majority seems to think that Congress intended such a meaning for the very same words in the very next subsection. Such a reading of § 1129(b)(2)(B)(ii) ignores the well-established cannon of statutory interpretation that "identical words used in different parts of the same act are intended to have the same meaning." *Sullivan v. Stroop*, 496 U.S. 478, 484 (1990) (quoting several prior Supreme Court cases); *see also United States v. Nippon Paper Indus. Co.*, 109 F.3d 1, 4-5 (1st Cir. 1997) ("It is a fundamental interpretive principle that identical words or terms used in different parts of the same act are intended to have the same meaning . . . . This principle—which the Court recently called 'the basic cannon of statutory construction'—operates not only when particular phrases appear in different sections of the same act, but also when they appear in different paragraphs or sentences of a single section.") (citations omitted), *petition for cert. filed*, 65 U.S.L.W. 3839 (U.S. June 13, 1997) (No. 96-1987).

Furthermore, I cannot subscribe to the notion that the language of § 1129(b)(2)(B)(ii) must be deemed ambiguous merely because the case law and the academic literature have interpreted it in different ways. The majority relies upon *Dewsnup* in stating that the "mere recitation of the possible interpretations" of the absolute priority rule renders § 1129's language ambiguous. *Ante*, at 17. But *Dewsnup* and other Supreme Court precedent also command courts to apply a statute's unambiguous language without looking beyond it. *See Dewsnup*, 502 U.S. at 419-20 ("Of course, where the language is unambiguous, silence in the legislative history cannot be controlling."); *Union Bank v. Wolas*, 502 U.S. 151, 155-56 (1991) ("Given the clarity of the statutory text, respondent's burden of persuading us that Congress intended to create or to preserve a special rule . . . is exceptionally heavy."); *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 240-41 (1989) ("[A]s long as the statutory scheme is coherent and consistent, there generally is no need for a court to inquire beyond the plain language of the statute."). As Justice Scalia noted in his dissent in *Dewsnup*, the Supreme Court has "*never* held pre-Code practice to be determinative in the face of . . . contradictory statutory text." *Dewsnup*, 502 U.S. at 433 (Scalia, J., dissenting).

A natural reading of § 1129(B)(2)(b)(ii) prohibits a junior interest holder from retaining property in the debtor "on account of" or "because of" its status as a prior interest holder. The Plan in this case gives LaSalle's partners the exclusive right to retain their ownership interest in the indebted property *because of* their status as a prior interest holder. Because the straightforward text of the statutory absolute priority rule prohibits such a Plan where there are dissenting, unsecured creditors, I see no need to look beyond the words of the statute.

II. Pre-Code Practice

Assuming, *arguendo*, that the language of § 1129(b)(2)(B)(ii) is ambiguous, a review of the pre-Code bankruptcy practice does not dictate the adoption of the new value exception. In *Dewsnup*, the Supreme Court noted that Congress did "not write 'on a clean slate'" when amending the bankruptcy laws and that the "Court has been reluctant to accept arguments that would interpret the Code, however vague the particular language under consideration might be, to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history." *Dewsnup*, 502 U.S. at 419. Because nearly everyone agrees that the legislative history "sheds little light" on the vitality of the new value exception, *see Bryson*, 961 F.2d at 504 n.13,[3] the majority uses *Dewsnup* to argue that we must interpret the Code to include the new value exception.

While pre-Code practices have long helped courts interpret ambiguous Bankruptcy Code provisions, they cannot require courts to read unestablished, disputed, or outdated pre-Code principles into the Code. *Dewsnup* understated its

---

[3] In this circuit, we have speculated inconclusively on the meaning of the sparse legislative history. Some cases have suggested that Congress's rejection of a proposal by the Bankruptcy Commission to modify the absolute priority rule and its exceptions reveals that Congress did not intend to include such an exception when enacting the Code. *See, e.g., Kham & Nate's*, 908 F.2d at 1261-62 (noting that Congress was aware of the rule and its exceptions when it adopted the "blanket" absolute priority rule without "suggest[ing] a single exception"). Other cases have pointed out, however, that the proposed (but rejected) rule sought to *ease* the requirements of the new value exception, and thus the "rejection of the modification could just as easily be construed as an endorsement of the status quo." *In re Snyder*, 967 F.2d 1126, 1130 (7th Cir. 1992).

point that Congress does not write on a clean slate when amending the bankruptcy laws because "Congress in fact writes bankruptcy laws on a very messy slate." *In re A.V.B.I., Inc.*, 143 B.R. 738, 746 (Bankr. C.D. Cal. 1992). For that reason, "[i]mporting concepts from past reorganization cases into interpretation of the Code must be done gingerly, with proper attention to the context in which the original case arose." *Id.*

In *Dewsnup*, for example, once the Court found the language of 11 U.S.C. § 506 to be ambiguous, its look at the pre-Code practice regarding the involuntary reduction of a creditor's lien arguably proved to be a fruitful venture. *See Dewsnup*, 502 U.S. at 419. *But see A.V.B.I.*, 143 B.R. at 744-47 (questioning *Dewsnup*'s conclusion regarding the established nature of the relevant pre-Code practice). The *Dewsnup* Court noted that its own cases had not permitted involuntary reductions and that, indeed, such reductions might face constitutional scrutiny under the Takings Clause. *See Dewsnup*, 502 U.S. at 419. *Dewsnup* also found legislative history suggesting that Congress intended for § 506(d) to permit liens to pass through bankruptcy unaffected. *See id.* The Court therefore reasoned that because the bankruptcy laws had never permitted such a reduction of a creditor's lien, Congress could not have intended to "grant a debtor [a] broad new remedy" without mentioning that remedy in the Code or the legislative history.[4] *Id.* at 420.

In the situation of the absolute priority rule, however, a critical look at the pre-Code practice does not reveal Congress's intent to include a new value exception in

---

[4] Justice Scalia's dissent in *Dewsnup* contends, however, that the language of § 506(a) & (d) unambiguously granted such a remedy. *See Dewsnup*, 502 U.S. at 420.

§ 1129(b)(2)(B)(ii). Rather, the Bankruptcy Code so fundamentally altered the pre-Code reorganization and confirmation procedures that strict adherence to the pre-Code new value exception might *contravene* Congress's intent in codifying the absolute priority rule.

The reasonableness of reading the pre-Code new value exception into the codified absolute priority rule is initially harmed by the questionable foundation upon which that exception rests. The Supreme Court's "creation" of the new value exception in *Case v. Los Angeles Lumber Prods., Co.*, 308 U.S. 106, 121-22 (1939), was merely *dicta* because the Court ultimately ruled that nonmonetary value cannot sufficiently satisfy any type of new value exception. *See Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 203-04 (1988); *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1361 (7th Cir. 1990). In addition, *Case* never remarked on whether creditors must consent to a plan that permits old equity holders to input new capital in order to retain ownership of the debtor even though the Supreme Court case upon which *Case's dicta* relied—*Kansas City Terminal Ry. v. Central Union Trust Co.*, 271 U.S. 445 (1926)—presented such a situation. *See Kham & Nate's*, 908 F.2d at 1361. Furthermore, the Supreme Court has never upheld the confirmation of a new value plan over a creditor's objection, *see A.V.B.I.*, 143 B.R. at 743, the Court has expressly stated that the vitality of the new value exception is an open issue, *see Ahlers*, 485 U.S. at 203 n.3, and the district and bankruptcy courts are divided on the issue, *see* J. Ronald Trost, et al., *Survey of the New Value Exception to the Absolute Priority Rule and the Preliminary Problem of Classification*, CA46 ALI-ABA 479, 540-43 (1995). "[L]ike other Supreme Court dicta," it seems that the "'new value' exception has taken on a life of its own in the lower courts." *A.V.B.I.*, 143 B.R. at 743 (citing John D. Ayer, *Rethinking Absolute Priority After* Ahlers, 87 Mich. L. Rev. 963, 1016

(1989)); *see also Kham & Nate's*, 908 F.2d at 1360 ("So far as the Supreme Court is concerned, however, the development [of the new value exception] has been 100% dicta."). And unlike *Dewsnup*, there is no express legislative history suggesting that Congress intended the exception to survive.

Moreover, the bankruptcy law principles underlying the "creation" and "development" of the new value exception differ greatly from those under the present Bankruptcy Code. Prior to the enactment of the Code in 1978, bankruptcy law consisted of a number of provisions differing from each other regarding the confirmation of reorganization plans and the existence of "fair and equitable" standards in those situations. In *Case*, for example, Section 77B of the Bankruptcy Act of 1898 required that creditors unanimously consent to a debtor's reorganization plan and that the plan meet a "fair and equitable" standard developed under the common law. *See Case*, 308 U.S. at 114-15; *Kham & Nate's*, 908 F.2d at 1360-61. Section 77B, which lasted only 4 years, quickly gave way to Chapters X and XI of the Bankruptcy Act. 7 Collier on Bankruptcy, ¶ 1129.04[4][c], at 1129-105 (Lawrence P. King ed., 15th rev. ed. 1997). Chapter X retained Section 77B's "fair and equitable" requirement, and it mandated the appointment of a disinterested trustee to control the reorganization of the debtor. *Id.* ¶ 1129.04[4][c], at 1129-106.[5] Chapter XI included a "fair and equitable" rule

[5] Under Chapter X, no shareholder ever convinced a court that it contributed sufficient value to retain an interest under the new value concept, and no reported case expressly adopted *Case*'s new value *dicta* as its holding until the Code's enactment in 1978. 7 Collier on Bankruptcy, ¶ 1129.04[4][c], at 1129-107.

when enacted in 1938, but that concept was repealed from Chapter XI in 1952. Id. ¶ 1129.04[4][b], at 1129-92 n.105.[6]

The enactment of the Bankruptcy Code in 1978, however, fundamentally changed this bankruptcy backdrop. Chapter 11 of the Code "reflects a melding of concepts derived from several [of these and other] distinct bodies of pre-Code law" combined with the "conscious purpose . . . to create a new chapter that represented the best of all these approaches to reorganization." *A.V.B.I.*, 143 B.R. at 746-47. Significantly, the Code eliminated the unanimous consent requirement among creditors, *see* 11 U.S.C. § 1126(c), and it required a "fair and equitable" test whenever an impaired class of creditors rejects a reorganization plan, *see* 11 U.S.C. § 1129(b)(l). The Code, moreover, provided the first codification of this "fair and equitable" test. *See* 11 U.S.C. § 1129(b)(2). The present, increased flexibility in confirming reorganization plans coupled with new codifications thus represents a significant change from pre-Code bankruptcy law and arguably renders the new value exception unnecessary. *See Greystone III*, 995 F.2d at 1282, 1285 (Jones, J., dissenting).

Current bankruptcy practice also differs from pre-Code practice because most Chapter 11 cases are now operated by debtors-in-possession rather than court-appointed trustees.

[6] Because the absolute priority rule no longer applied to Chapter XI proceedings after 1952, cases under that chapter did not address any new value issues. 7 Collier on Bankruptcy, ¶ 1129.04[4][c], at 1129-106 to 1129-107; *see also id.* ¶ 1129.04[4][a], at 1129-84 to 1129-85. The number of parties that could potentially seek application of new value principles further declined due to a preference for filing under Chapter XI rather than Chapter X, which is partially explained by Chapter X's disinterested trustee requirement. *Id.* ¶ 1129.04[4][c], at 1129-106.

See A.V.B.I., 143 B.R. at 743. When the Court decided *Case*, a new value exception to the absolute priority rule may not have been objectionable to creditors because the court-appointed trustee would presumably sell the property back to the equity holders only after it "examined the books and operations" and had not "unearthed any dishonesty or mismanagement." *Id.* The present Chapter 11 framework, however, "permits uninterrupted control by insiders," and therefore creates situations where creditors fear that the reorganizations "are run for the private benefit of existing salaried management and the equity holders, with the intent of unfairly squeezing out the creditors." *Id.*

The enactment of the Code further altered prior bankruptcy practice by removing bankruptcy judges' "equitable powers to modify contracts to achieve 'fair' distributions." *Kham & Nate's*, 908 F.2d at 1361. "[W]hatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code." *Ahlers*, 485 U.S. at 206. The notion that the Code, rather than equitable principles, permits a non-consensual plan to "sell" the indebted property to its old owners flies in the face of Chapter 11 and *Ahlers*: "The Court of Appeals may well have believed that petitioners or other unsecured creditors would be better off if respondents' reorganization plan was confirmed. But that determination is for the creditors to make in the manner specified by the Code." *Ahlers*, 485 U.S. at 207; *see also id.* (providing that "it is up to the creditors—and not the courts—to accept or reject a reorganization plan which . . . . fails to honor the absolute priority rule"). "In effect, Section 1129(b)(2)(B) of the Code gives the creditors—not the court—the right to decide whether to waive the absolute priority rule." *A.V.B.I.*, 143 B.R. at 744.

In light of the elimination of the unanimous consent requirement, the current trend of operation by debtors-in-possession, and the decrease of bankruptcy courts' equitable powers, retaining the "new value exception" arguably gives debtors a "broad new remedy"—exactly the sort of balance-upsetting interpretation that *Dewsnup* rejected. The present case is therefore more like *Wolas* than *Dewsnup*.

The debtor in *Wolas* maintained that 11 U.S.C. § 547(c)(2), which makes an exception to the rule authorizing a trustee to avoid certain property transfers made by a debtor within ninety days before bankruptcy, did not apply to payments on long-term debt. Although the text of § 547(c)(2) did not distinguish between long-term debt and short-term debt, the debtor argued, among other things, that Congress intended to codify the pre-Code "current expense" rule, which would ultimately limit § 547(c)(2)'s exception to short-term debt. *Wolas*, 502 U.S. at 158-59. The Court rejected this argument, reasoning that there was no extrinsic evidence or legislative history suggesting that Congress intended to codify the current expense rule. *Id.* at 159 & n.14. Significantly, the Court also noted that the Code substantially enlarged the trustee's power to avoid preferential transfers, and that it could not "assume that the justification for narrowly confining the 'current expense' exception" to certain situations before the enactment of the Code should apply to an exception in the Code. *Id.* at 159-60. Rather, "the fact that Congress carefully reexamined and entirely rewrote the preference provision in 1978 supports the conclusion that the text of § 547(c)(2) as enacted reflects the deliberate choice of Congress." *Id.* at 160; *see also id.* at 160 n.15 (citing the legislative history and noting that Congress intended to undo the "hopelessly complex" pre-Code preference section by proposing a "unified and coherent section to deal with the problems created by prebankruptcy preferential transfers"). In our case, as in *Wolas*, Congress significantly changed the

underlying law upon which the pre-Code absolute priority rule and new value exception relied by creating a new Chapter 11 to deal with reorganization procedures and requirements.

Keeping in mind the significant differences in the pre-Code bankruptcy environment, strict adherence to a tenuous pre-Code practice makes little sense. Even if *Dewsnup* repudiated prior bankruptcy statutory interpretation cases like *Wolas* and *Ron Pair* and effectively mandated a review of pre-Code practice in any case where the parties disagree on the meaning of the statute's language, *see Dewsnup*, 502 U.S. at 435 (Scalia, J., dissenting) ("I have the greatest sympathy for the Courts of Appeals who must predict which manner of statutory construction we shall use for the next Bankruptcy Code case."), the pre-Code rationale for the new value exception makes little sense in today's Chapter 11 environment. The majority, due to its uncritical adherence to *Dewsnup*, creates an anachronism by cutting and pasting pre-Code practice into a fundamentally different bankruptcy context. As a result, we are left with a new § 1129(b)(2)(B)(ii) that Congress likely never intended. For that reason, I must dissent from the majority's otherwise solid opinion.[7]

---

[7] In furthering its reasoning, the majority lists the significant advantages gained by the existence of a new value exception to the statutory absolute priority rule. *Ante*, at 20-21; *see also Bonner Mall*, 2 F.3d at 915-16; *Snyder*, 967 F.2d at 1130. Much ink has already been spilled debating the benefits and detriments of the new value exception in the context of Chapter 11, and my opinion will likely add little to the debate. I do, however, feel that the majority's policy arguments should not go unanswered.

Without question, the ability to infuse new capital from old equity holders provides a valuable tool for reorganizations. The

(continued...)

A true Copy:

Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

---

[7] (...continued)
creditors, however, should be able to make the ultimate decision regarding whether to incorporate such new value. *See Greystone III*, 995 F.2d at 1284, 1285 (Jones, J., dissenting) ("It is dubious to suppose that courts will ordinarily possess superior foresight than the creditors themselves concerning the creditors' best interests."). Rejection of the new value exception, moreover, will not extinguish "new value" as a beneficial tool for reorganization. *See Bryson*, 961 F.2d at 504 (noting that if a "plan represents a reasonable business risk, creditors should be willing to forego immediate recoveries in exchange for the expectation of greater recoveries in the future, in which case they would consent to viable plans providing for new capital infusions"). Creditors regularly consent to new value plans, *see A.V.B.I.*, 143 B.R. at 743, and they will continue to do so even when they are not faced with the threat of a cramdown, *see Kham & Nate's*, 908 F.2d at 1360 (noting that creditors effectively own bankrupt firms and that in many instances the creditors should be willing to consent to a voluntary plan that allows old equity holders to gain stock in return for inputting new value). Finally, providing this power to creditors alone, and removing it from the courts, will provide the incidental benefit of removing an "enormously complicating factor" from the "carefully balanced bargaining structure" used to formulate consensual reorganization plans. *Greystone III*, 995 F.2d at 1283-84, 1285 (Jones, J., dissenting); *cf. Bonner Mall*, 2 F.3d at 917 (discussing the need for bankruptcy courts to "carefully apply" the strictures of the new value exception in order to prevent old equity from circumventing the purpose of the absolute priority rule).

APPENDIX B

United States Court of Appeals

for the Seventh Circuit
Chicago, Illinois
November 25, 1997.

Before

Hon. WALTER J. CUMMINGS, Circuit Judge

Hon. KENNETH F. RIPPLE, Circuit Judge

Hon. MICHAEL S. KANNE, Circuit Judge

IN THE MATTER OF:	) Appeal from the United
	) States District Court for
203 N. LASALLE STREET	) the Northern District of
PARTNERSHIP, an Illinois	) Illinois, Eastern
Limited Partnership,	) Division.
	)
Debtor-Appellee,	)
	) No. 95 C 7144 and
	) 96 C 238.
Nos. 96-2137 & 96-2138	) Paul E. Plunkett,
	) Judge.
	)
APPEAL OF: BANK OF	)
AMERICA ILLINOIS,	)
	)
Appellant.	)

ORDER

On consideration of the petition for rehearing and suggestion for rehearing en banc filed by the appellant, Bank of America Illinois, on October 10, 1997, and amended on October 22, 1997, a majority of the panel voted to deny the petition for rehearing. A vote of the active members of the court was requested on the suggestion for rehearing en banc. The voting active judges* of the court have voted to deny hearing en banc.** Accordingly,

IT IS ORDERED that the petition for rehearing and suggestion for rehearing en banc be, and the same is hereby DENIED.

*Circuit Judge Joel M. Flaum did not participate in the consideration of the petition for rehearing en banc.

** Circuit Judges Coffey, Easterbrook, Manion, Kanne, and Diane P. Wood voted to grant rehearing en banc.

APPENDIX C

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

BANK OF AMERICA, ILLINOIS,	)	**Consolidated Cases**
	)	**Nos. 95 C 7144 & 96 C 0238**
Appellant,	)	
	)	
v.	)	**Appeal From**
	)	**No. 95 B 4998**
203 NORTH LASALLE STREET	)	**Chapter 11**
PARTNERSHIP, an Illinois	)	
limited partnership,	)	
	)	**Hon. Paul E. Plunkett**
Appellee.	)	

[April 30, 1996]

MEMORANDUM OPINION AND ORDER

The Appellant Bank of America, Illinois (the "Bank") appeals from three orders entered by the United States Bankruptcy Court for the Northern District of Illinois (Honorable Eugene Wedoff) in the underlying Chapter 11 case of 203 North LaSalle Street Partnership (the "Debtor"): an order (the "Confirmation Order") confirming over the objection of the Bank, the Debtor's major creditor, the Debtor's Second Amended Plan of Reorganization Dated September 11, 1995 as modified (the "Plan"), *In re 203 North LaSalle Street Limited Partnership*, 190 B.R. 567 (Bankr. N.D. Ill. 1995); and two orders denying the Bank's motion for relief from the automatic stay and the Bank's motion to convert the Debtor's Chapter 11 case to one under

Chapter 7 of the Bankruptcy Code (the "Code").[1] The Debtor also moves to dismiss the Bank's appeal as moot. For the reasons set forth below, we deny the Debtor's motion to dismiss the appeal and affirm the orders of the bankruptcy court in all aspects.

Background

We summarize the bankruptcy court's findings of fact, set forth in it Memorandum of Decision ("Bk. Dec.") as follows.

The Debtor is an Illinois limited partnership that owns the upper fifteen floors of office space (the "Property") in a building in the central business district of Chicago. The lower floors are separately owned. The Property is encumbered by a lien in favor of the Bank that secures a nonrecourse note in the principal amount of $92,582,000. The note became due and payable, according to its terms, on January 3, 1995. The debtor was unable to pay the note at that time, and the Bank commenced a state court foreclosure action on January 20, 1995. In response, the debtor filed this bankruptcy case on March 13, 1995. At that time, the Bank's claim, principal and interest, was $93,013,612. Several smaller claims were outstanding at the time of filing: (a) a state property tax claim of about $2.3 million; (b) general unsecured trade debt of about $160,000; (c) unsecured insider claims of $7.7 million (of which $6.8 million is a claim of the Debtor's general partner for an unsecured loan); and (d) a second mortgage held by the Debtor's general partner in the amount of $11.3 million. After the filing, the Debtor's general partner purchased some of the trade claims, reducing

---

[1] Unless otherwise specifically noted, all section references are to the Bankruptcy Code, 11 U.S.C. §§ 101 *et seq.*

the general unsecured claims held by non-insiders to about $90,000. In addition to its real property, the Debtor holds the right to a cash account, consisting of prepetition rents, that at the time of confirmation held approximately $3.1 million.

The Debtor proposed its original plan of reorganization on April 13, which was subsequently amended on May 12. After briefing and a hearing, the bankruptcy court denied confirmation of the plan on August 7. The principal ground for the ruling was unfeasibility: the minimum interest rate that the court found to be required for payment of the Bank's secured claim could not be supported by the projected cash flow of the Property. However, because the question of the appropriate interest rate was an unsettled legal issue, the court allowed the Debtor an opportunity to amend its plan. After several revisions, the debtor proposed the plan dated September 11. The court again held a hearing and ultimately confirmed the Plan in an order dated December 6, 1995.

The principal factual dispute between the parties concerned the value of the Property and the cash flow it was likely to generate. Both the Debtor and the Bank presented expert appraisal testimony on these issues, and the experts agreed that the most appropriate valuation method was discounted cash flow. This technique operates in three steps. First, the appraiser estimates the cash flow that the property will generate each year of a several year holding period. Next, the appraiser determines the "reversionary" value of the property at the end of the period by capitalizing a stabilized income that is estimated to produce at that time. Finally, using an appropriate discount rate, the appraiser reduces the values derived in the first two steps to present values and combines them to arrive at the value of the property. The bankruptcy court accepted the discounted cash flow method. Thus, to arrive at a value of the property, it

was necessary to: (1) estimate net cash flows over an appropriate holding period; (2) determine an appropriate capitalization rate for the reversion; and (3) determine an appropriate discount rate.

Each of the appraisers chose a period of ten years for estimating annual cash flow, then capitalized a stabilized income for the eleventh year. The appraisers differed, however, in their estimates of income and in the capitalization and discount rates they applied. The Debtor's appraiser applied a higher discount rate (14.367%) to overall higher income estimates; the Bank's appraiser used both a lower discount rate (11.75%) and lower income estimates. The Debtor's estimated cash flow for the ten years was $58.285 million leading to a present value of $28.628 million. The Bank's estimated cash flow was $48.077 million leading to a present value of $27.457 million—about $1.1 million lower than the Debtor's.

The appraisers also differed in their calculation of reversionary value, but the Debtor's valuation was about $4.8 million less than the Bank's. In sum, the Debtor arrived at an estimated value of $53.75 million, while the Bank arrived at an estimated value of $57.4 million.

The bankruptcy court did not accept either of these valuations. The future cash flows depend primarily on the renewal of leases. The Property is currently nearly fully leased, but two leases to major tenants will expire during the ten year period. The debtor negotiated a renewal of one of these leases, to Rudnick & Wolfe, contingent on confirmation of the Plan, and that renewal is reflected in the appraisers' estimates of cash flow. However, the other major tenant, Coopers & Lybrand, has not agreed to renew its lease. The Bank's appraiser treated this tenant's lease in the same way as other smaller tenants, estimating a 50% chance of renewal.

The Debtor's appraiser, on the other hand, assumed a one hundred percent chance of renewal and assumed highly favorable circumstances in that renewal. The bankruptcy court's assessment of the situation lay generally between those of the appraisers. It found that the size of the space occupied by the tenant and the paucity of available alternative space made it very likely that the tenant would renew, but that the importance of that tenant to the Debtor's operations would likely allow it concessions that would depress the debtor's cash flow under the renewed lease. Thus the court's estimate reflected no extraordinary loss at the time of the lease expiration, but lower income thereafter than suggested by either appraiser.

The bankruptcy court also found that the difference in capitalization and discount rates of the appraisers reflected their different approaches to income estimation. The Debtor's appraiser set both rates at the high end of the spectrum of reasonable rates to reflect its view that the cash flow projections were somewhat risky, whereas the Bank's appraiser used lower rates to reflect its belief in the high quality of the building and perhaps the conservative estimate of cash flow. The court's view was that if income is properly estimated based on likely leasing results, the rates employed should be those of an average building of the Debtor's type—in this case, a first-class office building in the central business district. From data presented by the appraisers, the court took these rates to be a 10% terminal capitalization rate and a 12% discount rate.

Applying the 12% discount rate to future cash flows as found by the court, the court found a present value over the ten-year period of $30.0 million, as follows:

Year Ending	Estimated Cash Flow (in $ thousands)	Present Value (discounted at 12%)
1996	4,100	3,661
1997	5,700	4,545
1998	5,300	3,772
1999	5,700	3,621
2000	6,900	3,916
2001	7,300	3,698
2002	1,000	452
2003	3,800	1,538
2004	6,500	2,344
2005	7,700	2,479
Total	54,000	30,026

The court then calculated the present value of the reversion, based on stabilized income in the eleventh year of $8.2 million, capitalized at 10%, as $25.8 million, as follows:

Estimated Stabilized Income (in $ thousands)	8,200
Capitalization Rate	.10
Gross Reversionary Value	82,000
Estimated Disposition Cost	1,845 (2.25%)
Net Reversionary Value	80,155
Discount Rate	.12
Present Value	25,806

The bankruptcy court thus calculated the value of the Property, at the time of the confirmation hearing, as $55.8 million.

The claims and interests in the Plan are divided into the following classes, of which classes 1 and 2 are unimpaired, and classes 3-7 are impaired:

Class 1: Priority Claims.

Class 2: Secured tax claims.

Class 3: Secured claim of the Bank.

Class 4: All unsecured claims, other than those in classes 1, 5, and 6.

Class 5: The Bank's deficiency claim.

Class 6: Claim of North Street Limited Partnership secured by its pre-petition second mortgage on the Property.

Class 7: The interests of the Debtor's general and limited partners.

The bankruptcy court summarized the major features of the Plan, relevant to its confirmation decision as follows:

> (1) The debtor's partners would contribute a total of $6.125 million in new capital to the debtor over the life of the plan, $3 million on the day after the effective date of the plan, and $625,000 on each of the next five anniversaries of the effective date. The payment of the five annual installments would be secured by a continuing letter of credit in the amount of $1,125,000.
>
> (2) Priority and tax claims would be paid in full, within 30 days of the effective date of the plan, from funds currently on deposit.
>
> (3) The trade creditors would be paid in full, without interest, 180 days after the effective date of the plan. Upon confirmation, the insiders would waive the general unsecured claims that they hold (including, apparently, the claims purchased by the general partner).
>
> (4) The bank's secured claim, fixed at $54,544,500 would be paid partly in cash ($1,149,500 within five days of the effective date of the plan), and partly through an interest bearing note, secured by the bank's lien on the

property. Monthly payments would be made on the note, on a thirty-year amortization schedule, and the note would mature in seven years, extendable to ten years at the debtor's option, upon certain conditions. The principal of the note would further be reduced by monthly payments to the bank of the excess cash flow of the property. The note would compensate the bank for its extension of credit in three ways: first, a commitment fee in an amount between $266,975 and $545,000 to be determined by the court; second, fixed "base interest" at a rate 3½ per cent over the rate of U.S. treasury obligations maturing 7 years after the effective date of the plan; and, third, "participation interest" of 50% of the net value of the property, either as realized in a sale, or as appraised at the time of any refinancing.

(5) From the remaining value of the property at the time of sale or refinance, payments would be made in the following order: (a) on the unsecured deficiency claim of the bank, payment in full, without interest; (b) for the new capital contributions, payment in full, with interest at varying rates; (c) on the second mortgage held by the general partner, full payment with 10% simple interest; and (d) to the debtor's partners in proportion to their contribution of new capital.

(6) In the event of any default in making the new capital contributions or in making payments under the note, a deed to the debtor's property, held in escrow by a title company, is to be conveyed to the bank. The plan also has a number of features designed to minimize the

possibility of any future bankruptcy filing interfering with the bank's right to obtain this conveyance.

(Bk. Dec. at 7-8.)

The bankruptcy court acknowledged that this Plan, and indeed, the entire bankruptcy case, was filed by the Debtor primarily to avoid severe tax consequences to the Debtor's partners of a foreclosure sale of the Property. The collective liability of the partners, in the event of foreclosure, is estimated at $20 million.

The general unsecured creditors in the class defined by the Plan voted in favor of the Plan; the only votes against confirmation were those of claims held or purchased by the Bank.

Motion to Dismiss the Appeal

The Debtor moves to dismiss as moot the Bank's appeal on the grounds that the Debtor has already implemented the Plan and substantial confirmation (as defined in section 1101(b)) has occurred. It contends that, under the circumstances of this case, it is no longer possible for the Court to grant meaningful relief to the Bank.

In particular, the Debtor contends that numerous good faith transfers have already occurred that cannot be undone: (1) the investors have acquired equity in the Debtor, which, in turn, has acquired the Property; (2) Rudnick & Wolfe has acquired a leasehold interest in the Property; (3) numerous other payments required under the Plan have been made. Furthermore, the cash advanced by the Debtor's investors, who are not parties to the case, have already been used to make payments under the Plan and cannot be recovered.

Their interests would thus be adversely affected. Rudnick & Wolfe—whose entering into its lease was contingent on confirmation of the Plan and also not a party to the case—would be adversely affected, because it has already given up the opportunity to move to another building and has also spent considerable sums to redecorate its space and acquire new equipment.

The bank contends, to the contrary, that the Debtor overstates the irreversibility of its implementation of the Plan. The Bank simply seeks to foreclose its mortgage. It contends that the return of payments to the trade debt creditors and the real estate tax payments, as well as several other payments, are not necessary for it to pursue a foreclosure. Furthermore, the Bank is in favor of the Rudnick & Wolfe lease extension and would not disturb any aspect of it. The transactions involving the Bank are at the heart of this appeal and can be easily undone: the Bank will return any payments necessary to insure that it has received no more than it would had the Plan not been confirmed and will return any documents it has received under the Plan. The Bank also agrees to leave any post-petition service contracts undisturbed. Moreover, the Bank is prepared to fund the repayment of any amount advanced by the investors, as well as any ancillary amounts necessary to accomplish this.

The Confirmation Order does not involve complex transactions. We are persuaded by the Bank's arguments that, in the event of reversal, the implementation of the Plan can be undone without undue difficulty and without harm to third parties. We therefore deny the Debtor's motion to dismiss the appeal as moot.

Appeal of the Confirmation Order

On an appeal from the bankruptcy court, the district court "may affirm, modify, or reverse a bankruptcy judge's judgment, order, or decree or remand with instructions for further proceedings." 11 U.S.C. Fed. R. Bankr. Proc. 8013 ("Rule 8013"). The district court shall not set aside the bankruptcy court's findings of fact unless clearly erroneous, *In re Tolona Pizza Products Corp.*, 3 F.3d 1029, 1033 (7th Cir. 1993), and shall not overturn them so long as they are "plausible in light of the record viewed in its entirety." Rule 8013; *Levinson v. United States*, 969 F.2d 260, 265 (7th Cir.), cert. denied, 506 U.S. 989 (1992) (citing *Anderson v. City of Bessemer City, North Carolina*, 470 U.S. 564, 574 (1985)). Meanwhile, the district court reviews the bankruptcy court's conclusions of law *de novo*. *Meyer v. Rigdon*, 36 F.3d 1375, 178 (7th Cir. 1994); *Woodbridge Place Apartments v. Washington Square Capital, Inc.*, 965 F.2d 1429, 1434 (7th Cir. 1992).

The Bank argues on appeal that the bankruptcy court erred in concluding that the Debtor had established that the Plan satisfied the requirements of 11 U.S.C. § 1129;[2] and that

---

[2] Section 1129 states, in relevant part:

(a) The court shall confirm a plan only if all of the following requirements are met:

(1) The plan complies with the applicable provisions of this title.

(2) The proponent of the plan complies with the applicable provisions of this title.

(3) The plan has been proposed in good faith and not by any means forbidden by law.

(continued...)

[2] (...continued)

. . . . .

(5)(A)(i) The proponent of the plan has disclosed the identity and affiliations of any individual proposed to serve, after confirmation of the plan, as a director, officer, or voting trustee of the debtor, an affiliate of the debtor participating in a joint plan with the debtor, or a successor to the debtor under the plan; and

(ii) the appointment to, or continuance in, such office of such individual, is consistent with the interests of creditors and equity security holders and with public policy; and

(B) the proponent of the plan has disclosed the identity of any insider that will be employed or retained by the reorganized debtor, and the nature of any compensation for such insider.

. . . . .

(7) With respect to each impaired class of claims or interests—

(A) each holder of a claim or interest of such class—

(i) has accepted the plan; or

(ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date; or

(B) if section 1111(b)(2) of this title applies to the claims of such class, each holder of a claim of such class will receive or retain under the plan on account of such claim property of a value, as of the effective date of the plan, that is not less than the value of such holder's interest in the estate's interest in the property that secures such claims.

. . . .

(10) If a class of claims is impaired under the plan, at least one class of claims that is impaired under the plan has accepted the plan, determined without including any acceptance of the plan by any insider.

(11) Confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of

(continued...)

[2] (...continued)

the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan.

. . . .

(b)(1) Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.

(2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:

(A) With respect to a class of secured claims, the plan provides—

(i)(I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(II) that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

(ii) for the sale, subject to section 363(k) of this title, of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens on proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claims.

(B) With respect to a class of unsecured claims—

(continued...)

it erred in entering the Confirmation Order based on that conclusion. In arguing that the bankruptcy court did so err, the Bank raises the following issues:

1. Whether the Bankruptcy Court erred as a matter of law or fact in concluding that the Plan was proposed in good faith as required by § 1129(a)(3).

2. Whether the Bankruptcy Court erred as a matter of law or fact in concluding that the continuation of North LaSalle, the Debtor's sole remaining general partner, in control of the Debtor was in the interests of creditors and consistent with public policy as required pursuant to § 1129(a)(5).

---

[2] (...continued)

(i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or

(ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

(C) With respect to a class of interests—

(i) the plan provides that each holder of an interest of such class receive or retain on account of such interest property of a value, as of the effective date of the plan, equal to the greatest of the allowed amount of any fixed liquidation preference to which such holder is entitled, any fixed redemption price to which such holder is entitled, or the value of such interest; or

(ii) the holder of any interest that is junior to the interests of such class will not receive or retain under the plan on account of such junior interest any property.

3. Whether the Bankruptcy Court erred in concluding that the Debtor had satisfied the impaired accepting class requirement of § 1129(a)(10).

4. Whether the Bankruptcy Court erred as a matter of law or fact in concluding that the Plan did not unfairly discriminate against [the Bank's] unsecured claim in violation of § 1129(b)(1).

5. Whether the Bankruptcy Court erred as a matter of law in concluding that the unsecured or otherwise unsupported promissory notes of the Debtor's partners could be considered for any purpose.

6. Whether the Bankruptcy Court erred as a matter of law in concluding that the "new value" exception to the absolute priority rule continues to exist under the Bankruptcy Code.

7. Whether the Bankruptcy Court otherwise abused its discretion in finding that the Plan satisfies the "new value" exception to the absolute priority rule.

8. Whether the Bankruptcy Court erred as a matter of law or fact in concluding that the Plan was feasible under § 1129(a)(11), notwithstanding that the Bankruptcy found that the Debtor will experience negative cash flow in years seven and eight of the Plan, which the Debtor itself estimates to be at least $5 million.

9. Whether the Bankruptcy Court erred as a matter of law in concluding that the Plan was feasible under § 1129(a)(11) based on the Plan's provisions providing that a deed conveying the Property to the Bank is to be placed in escrow on the effective date of the Plan and delivered and

recorded upon the occurrence of an event of default under the Plan.

10. Whether the Bankruptcy Court otherwise abused its discretion in finding that the Plan was feasible under § 1129(a)(11).

11. Whether the Bankruptcy Court erred as a matter of law, or otherwise abused its discretion, in concluding that the Plan provides fair and equitable treatment of the Bank's secured claim because the GECC Letter of Intent—the purported basis of the terms and conditions governing the treatment of the Bank's secured claim under the Plan (including the interest rate)—was a "market" proposal.

12. Whether the Bankruptcy Court otherwise abused its discretion in finding that the Plan provides for fair and equitable treatment of [the Bank's] secured claim.

13. Whether the Bankruptcy Court erred as a matter of law by deducting the hypothetical costs of disposition from the value of the Property to determine the amount of [the Bank's] secured claim.

14. Whether the Bankruptcy Court abused its discretion in finding that the Plan satisfied the "best interests" test under § 1129(a)(7) without its providing for the payment of interest on the Class 4 Claims.

(Appellant's Br. at 4-6.)

It is apparent that the Bank raised all or nearly all of these issues before the bankruptcy court, and in substantially the same form. In a lengthy Memorandum of Decision, the bankruptcy court thoroughly explored all of the Bank's objections. In order to affirm the Confirmation Order, we

must uphold the decision of the bankruptcy court on each of these issues. *See, e.g., In re Rusty Jones, Inc.*, 110 B.R. 362, 373 (Bankr. N.D. Ill.1990). We discuss each of the Bank's objections in turn.

I. *Good Faith Proposal of Plan*

The Bank contends that since the primary purpose of the Plan, as found by the bankruptcy court, was to help the debtor's sophisticated investors avoid adverse income tax consequences that they would experience as a result of the Bank's foreclosure of its mortgage, the Plan violates the requirement of section 1129(a)(3) that the Plan be "proposed in good faith and not by any means forbidden by law."

The standards for "good faith" proposal of a plan are set forth in *In re Madison Hotel Associates*, 749 F.2d 410, 425 (7th Cir. 1984). The Seventh Circuit interpreted "good faith" to mean "that there exists 'a reasonable likelihood that the plan will achieve a result consistent with the objectives and purposes of the Bankruptcy Code.'" *Id. (quoting In re Nite Lite Inns*, 17 B.R. 367, 370 (Bankr. S.D. Cal. 1982)). Similarly, the "good faith" requirement "require[s] the bankruptcy court to review the proposed plan for accuracy and 'a fundamental fairness in dealing with one's creditors.'" *Id.* (*quoting In re Rimgale*, 669 F.2d 426, 432-33 (7th Cir. 1982)). "Thus, for purposes of determining good faith under section 1129(a)(3) . . . the important point of inquiry is the plan itself and whether such plan will fairly achieve a result consistent with the objectives and purposes of the Bankruptcy Code." *Id.* The *Madison Hotel* court explicitly distinguished the determination under section 1129(a)(3) of whether a plan is *proposed* in good faith from the determination of whether the Chapter 11 petition for reorganization was *filed* in good faith. *Id.* The court thus held that the district court had erroneously construed section 1129(a)(3) when it evaluated

the pre-filing conduct of the debtor as well as the feasibility of the plan itself. Thus, we will not consider the motive of the Debtor or its partners in filing their Chapter 11 petition in determining whether or not its Plan fulfills the good faith requirement for confirmation.

Even were good faith in *filing* an issue, the Debtor's motive to avoid adverse consequences would still not constitute bad faith. *In re Cadwell's Corners Partnership*, 174 B.R. 744, 762 (Bankr. N.D. Ill. 1994) (holding that concern about tax consequences of foreclosure is alone insufficient to establish bad faith). This result also comports with the holding of *In re James Wilson Associates*, 965 F.2d 160, 170 (7th Cir. 1992): "It is not bad faith to seek to gain an advantage from declaring bankruptcy—why else would one declare it?" This was in response to the argument by the principal creditor that the sole purpose of the entire bankruptcy proceeding was to squirrel away the rents where the receiver couldn't get at them. It is difficult to see how this differs materially from the Bank's argument in this case. The Seventh Circuit opined that the clearest case of bad faith would be "where the debtor enters Chapter 11 knowing that there is no chance to reorganize his business and hoping merely to stave off the evil day when the creditors take control of his business." *Id.* In addition, bad faith filing is found where the debtor is able to pay its creditors in the ordinary course, where there is no prospect for reorganization, and where filing is for purposes of harassment. *In re N.R. Guaranteed Retirement, Inc.*, 112 B.R. 263 (Bankr. N.D. Ill.), *aff'd* 119 B.R. 149 (N.D. Ill. 1990).

The Bank's reliance on *In re Love*, 957 F.2d 1350, 1358-59 (7th Cir. 1992) for the proposition that a plan motivated primarily to avoid adverse tax consequences is proposed in bad faith is misplaced. *In re Love* involved a Chapter 13 petition filed by a member of a tax protest group

who had submitted false W-4 forms, and continued to do so after the Internal Revenue Service ("IRS") instructed his employer not to accept them. He also did not file his federal income tax forms for the years 1981 through 1985 until 1986. As result of these and other activities, as well as refusal to pay assessed income taxes, the IRS initiated levies against the protester. He then filed his Chapter 13 petition, as the court found, to avoid paying assessed taxes, much of which, under the circumstances of the case, did not constitute priority claims. *Id.* Unlike that case, the Debtor does not seek to avoid taxes already incurred, but to structure its transactions so as to avoid incurring tax liability. *See In re Sherwood Square Assocs.*, 107 B.R. 872, 876 (Bankr. D. Md. 1989) (holding that a desire to avoid tax consequences by the debtor's partners is not bad faith, in contrast to a situation where the only asset of a debtor is a tax loss).

The Bank's reliance on *In re Castleton Associates Limited Partnership*, 109 B.R. 347 (Bankr. S.D. Ind. 1989) is likewise unavailing. In *Castleton*, the question was whether a Chapter 11 petition was *filed* in good faith pursuant to section 1112(b). Furthermore, the debtor was a partnership whose sole asset was a residential apartment complex that was unable to generate enough income to meet operating expenses. The debtor did not even operate the business, but contracted out to a management company the everyday duties of maintaining and managing the complex. Thus, unlike this case, the debtor really had no business of its own to preserve—merely an investment. *Id.* at 350.

The Bank further argues that the bankruptcy court's factual findings that the Plan was proposed in good faith is clearly erroneous because "[i]t is undisputed that the entire risk of the Plan on creditors falls on" the Bank. It points to the provisions for prompt payment of the full amount of principal to all other non-insider creditors, to the cash flow

shortages in years seven and eight, and asserts that the insider creditors—to the extent that they have any claims—do not expect to receive, and are unlikely to receive, any distribution on their claims and that the Debtor's investors stand to receive no economic benefit from the Property. It argues that the Debtor's partners could have contributed a greater amount of new capital and that the feasibility of the Plan depends entirely on the Bank's willingness to relend excess cash flow payments in years seven and eight. In sum, the Bank contends that the full risk of the Plan is placed on it, not to maximize the value of the estate for creditors, but to allow the Debtor's investors to avoid adverse tax consequences.

Many of the Bank's assertions are raised in other of it's objections and will be addressed more specifically as we discuss each of them below. We will then return to the general fairness issue. The Bank cites no law concerning how risk is to be distributed among *creditors*. Suffice it to say that the Debtor's investors also take on considerable risk through their $3 million cash investment, their execution of notes obliging them to make annual payments of $625,000, their purchase of a letter of credit, and their granting of additional security interests to the Bank in the form of a commitment fee, an initial $1.149 million payment, and to fund the cost of Rudnick & Wolfe's lease extension. Furthermore, the bankruptcy court found that the Bank's risk is considerably less than it seems to argue. The cash shortfall in years seven and eight arise from projected costs in extending the lease of Coopers & Lybrand and will result in an enhanced value to the Property—and the Bank has a right to disapprove lease transactions and not to relend excess cash flow payments. Moreover, the Bank is entitled to automatic transfer of the title of the Property in the event of a default. The Bank's own appraiser testified to the improving market for buildings like the Property; thus, the Bank will enjoy a comfortable equity cushion—as a result both of the increase

in equity and the paying down of the principal on its secured claim.

We conclude that the bankruptcy court's factual finding that the Plan was proposed in good faith is amply supported and is not clearly erroneous.

II. *Continuation of Debtor's Present Management*

Section 1129(a)(5)(A)(ii) requires that the continuation of the Debtor's present management under a plan be "consistent with the interests of creditors and equity security holders and with public policy." The Bank contends that the continuation of the Debtor's management is not in the interests of creditors and public policy because, before filing the petition, these managers failed to use pre-petition rents for timely payment of real estate taxes. The Bank further contends that this failure was motivated solely by a desire to improve the Debtor's bargaining leverage vis-a-vis the Bank. The Bank argues that because nonpayment of real estate taxes constitutes waste under Illinois law, the Debtor's willingness to engage in nonpayment makes continuation of management contrary to the interests of creditors.

The cases relied upon by the Bank do not support its contentions as they apply to this case. In particular, nonpayment of real estate taxes *may* constitute waste if such nonpayment harms the creditors. *Hausmann v. Hausmann*, 596 N.E.2d 216, 220 (1992) (Ill. App. Ct. 1992). Courts have found that nonpayment of taxes constitute waste where such nonpayment is continuous and resulted in repayment of such taxes by the principal creditor after foreclosure or a tax sale of the property in question. *Hausmann, supra; North Am. Security Life Ins. Co. v. Harris Trust & Sav. Bank*, 859 F. Supp. 1163 (N.D. Ill. 1994); *Capitol Bankers Life Ins. Co. v. Amalgamated Trust & Sav. Bank*, No. 92 C 4480, 1993

WL 594103 (N.D. Ill. May 6, 1993), *aff'd*, 16 F.3d 1225 (7th Cir. 1994). In this case, there was no continuous practice of nonpayment of real estate taxes, but rather a single transfer of rental income into an account that remained in the control of the Debtor. The bankruptcy court found that this transfer was an error in judgment—it exposed the Debtor unnecessarily to tax penalties and was unlikely to achieve its intended purpose of advancing settlement discussions with the Bank—but that it is not indicative of a general course of conduct prejudicial to creditors. The Bank points to no facts that would indicate that this finding is clearly erroneous, and we therefore accept it. In fact, the single delinquent installment of real estate taxes has been paid pursuant to section 3.2 of the Plan. Moreover, the difference between the monthly penalties that accrued on the unpaid taxes and the earnings on the Debtor's cash were paid by the Debtor's management company. Thus, neither the Bank nor the Property were injured in any way by the delay in payment.

III. *Artificial Impairment*

Section 1129(a)(10) requires that, if any class of claims are impaired under a plan, at least one of those classes must accept the plan, without including any acceptance of the plan by any insider. Since the Bank did not accept the Plan, the only non-insider class remaining is the class of trade debt claims, which did accept the Plan. The Bank contends that the acceptance of the Plan by this class should be disregarded, because there was no valid reason to impair those claims—they total only $90,000, and the Debtor had more than enough resources to pay them in full, with interest, on the effective date of the Plan.

The Bank relies on *In re Windsor on the River Associates*, 7 F.3d 127 (8th Cir. 1993). In *Windsor*, the debtor, whose sole asset was a 298-unit apartment complex,

proposed a plan that impaired a class of trade creditors by providing for the payment of those claims 60 days after the effective date of the plan. The Eighth Circuit refused to recognize this impairment, holding that "for purposes of 11 U.S.C. 1129(a)(10), a claim is not impaired if the alteration of rights in question arises solely from the debtor's exercise of discretion." *Id.* at 132. The court found that an "arbitrary manipulation" had taken place, "the only purpose" of which was "to ensure approval by at least one 'impaired' class as required by section 1129(a)(10)." *Id.* at 133.

The bankruptcy court read *Windsor* as "requir[ing] the denial of confirmation in any case where it would be possible to structure a plan without an approving impaired class" (Bk. Dec. at 3.8), then discussed the rejection of this rule by the Ninth Circuit Bankruptcy Appellate Panel as unsupported by the language of the Code and as inconsistent with the Code's policy of flexibility in plan formulation. *See In re Hotel Assocs. of Tucson*, 165 B.R. 470, 475 (Bankr. 9th Cir. 1994); *accord, In re Beare Co.*, 177 B.R. 886 (Bankr. W.D. Tenn. 1994). Other courts have confirmed plans over objections of artificial impairment because the debtor showed that the impairment, although not absolutely essential, was desirable for other purposes and not solely to achieve impairment. *In re Duval Manor Assocs.*, 191 B.R. 622 (Bankr. E.D. Pa. 1996); *In re Rivers End Apartments, Ltd.*, 167 B.R. 470, 479 (Bankr. S.D. Ohio 1994). Indeed, in a wide-ranging discussion, the court in *Duval Manor* indicated that the issue of allowing artificially impaired classes under section 1129(a)(10) was a "cutting-edge" issue in bankruptcy today and that courts could be found on both sides of the issue. *Duval Manor, supra,* at 626–29. The court concluded that restricting artificial impairment could itself give rise to a "Pandora's box" of related problems. *Id.* at 629. *See also* Eric W. Lam, *On the River of Artificial and Arbitrary*

Impairment: An Erroneous Analysis, 70 N.D. L. Rev. 993 (1994).

The bankruptcy court found that the trade claims were not impaired solely for the purposes of insuring compliance with section 1129(a)(10). The operating income is not projected to provide sufficient income to pay all unsecured claims in full, with interest. Thus, the debtor had to impair claims. The court found that the Plan's manner of doing so is highly favorable to non-insider claims by providing for payment of the principal of those claims before payment of any insider claims. Though the Debtor could have structured the Plan to provide payment of the trade debt claims in full with interest, doing so would have reduced the amount available to satisfy other claims, including those of the Bank, and would have made confirmation more difficult. (See our discussion of the Bank's fourth objection, *infra*, in regard to treatment of trade debt claims.) This is in marked contrast to the situation in *Windsor*, where the only impairment is a sixty-day delay in payment—thus, no other class could have been affected in any way by the choice to impair. We think, in fact, that the bankruptcy court read *Windsor's* holding too broadly—it does not require the denial of confirmation in any case where it would be possible to structure a plan without an approving impaired class. The *Windsor* court made clear that the only purpose to be served by the proposed impairment before it was to insure an impaired class—it noted that the "[d]ebtor never presented a plausible alternative explanation." *Windsor, supra*, at 133. Given the unsettled nature of the law on this issue—the Seventh Circuit has not spoken—we conclude that the bankruptcy court did not err as a matter of law in finding that the Plan complies with section 1129(a)(10). Furthermore, '[w]hether Debtor manipulated the terms of its plan for purposes of securing confirmation is a question of fact." *Id.* at 132. We conclude that the

bankruptcy court's finding that the trade debt class was legitimately impaired is not clearly erroneous.

IV. *Unfair Discrimination Against the Bank's Unsecured Deficiency Claim*

The Bank contends that the Plan violates section 1129(b)(1), which requires that a plan "not discriminate unfairly . . . with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." In particular, the Bank contends that since its unsecured deficiency claim is not to receive any distribution until the sale or refinancing of the Property—which is not expected for seven or ten years and even then, the court found, the present value of the Bank's distribution does not exceed 16% of the Bank's claim—while the other unsecured non-insider creditors are to receive 100% of the principal amount of their claims on the effective date of the Plan, its deficiency claim is discriminated against unfairly.

At the outset, we note that the Seventh Circuit has interpreted sections 1111(b)[3] and 1122(a)[4] to require that the unsecured deficiency claim of a secured creditor, where the

---

[3] Section 1111(b) creates an unsecured deficiency claim of an undersecured creditor for the amount that the total lien exceeds the value of the collateral. Such a creditor may waive its deficiency claim and elect to have its claim treated as secured for the entire amount of the debt.

[4] Section 1122(a) provides that

> a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class.

debtor's sole asset is fully encumbered, be classified separately from the general unsecured creditors, because the legal rights of such a claimant are different from those of a general unsecured claimant. *In re Woodbrook Assocs.*, 19 F.3d 312, 319 (7th Cir. 1994). Clearly some discrimination between these classes must be permissible. *In re Aztec Co.*, 107 B.R. 585, 588-89 (Bankr. M.D. Tenn. 1989). The critical question then is not whether there is discrimination, but whether such discrimination is unfair.

The Bank relies on *Woodbrook* and *Aztec*. In *Woodbrook*, a provision providing for a 5% distribution to an section 1111(b) unsecured deficiency claim while providing for payment in full to the other unsecured claimants was found to discriminate unfairly. However, as the bankruptcy court noted, the *Woodbrook* court also found that the other unsecured creditors were in fact insiders and it did not discuss its general understanding of unfair discrimination. The bankruptcy court concluded that it is possible to lay a framework for measuring the fairness of a discrimination in Chapter 11 plans in two steps. First, any discrimination must be supported by a legally acceptable rationale, and, secondly, the extent of the discrimination must be necessary in light of that rationale. In this view, the discrimination in *Woodbrook* is unfair because favoring insiders at the expense of the deficiency claim, at least at the extreme disproportionality contemplated in that plan, could not be justified. In this case, the bankruptcy court concluded that the Debtor had provided a compelling rationale for its disparate treatment of unsecured claims: the best interests test as set forth in section 1129(a)(7), which requires that the debtor pay holders of impaired claims as much as they would have received in a Chapter 7 liquidation. The trade creditors in this case would have been paid in full under Chapter 7, while the Bank's unsecured deficiency claim would receive nothing. Thus, in order to be confirmed, the Plan must provide for full payment

of the trade debt. Since the Debtor cannot then pay all of its creditors in full, at least some must be paid less than their full claim—as long as they receive at least as much as they would have received under Chapter 7. The bankruptcy court next found that the discrimination in the Plan is narrowly tailored to meet the requirements of the "best interests" test: the trade creditors receive only the principal amount of their claims and all insider claims are either waived or subordinated to the Bank's deficiency claim. The bankruptcy court concluded that this treatment is not unfair.

The Bank asserts that *Aztec* controls in this case, in its rejection of the proposition that the requirements of the "best interests" test provide a rational basis, in and of themselves, for discriminating against a deficiency claim that arises solely by virtue of section 1111(b). It further asserts that the Seventh Circuit itself relied on this holding in its reliance on *Aztec* in *Woodbrook*. The Bank both misreads *Woodbrook* and misapplies *Aztec* to this case. *Aztec* is cited in *Woodbrook* in support of the holding of the latter that a Plan that discriminates by providing *de minimis* treatment to a deficiency claim while providing substantially more favorable treatment to insider claims, discriminates unfairly and cannot be confirmed. More importantly, the *Aztec* court found an additional basis for finding the discrimination to be unfair where the *de minimis* treatment of the deficiency claim—in relation to insider claims—was *justified* on the basis that the deficiency claim would receive no more under a chapter 7 liquidation. In contrast, the Bank's deficiency claim does receive more favorable treatment than it would in a chapter 7 liquidation, and its failure to receive even better treatment is not at the expense of insider claims, but because the trade debt claims *must* be treated at the level they are in order to satisfy the "best interests" test. We conclude that the bankruptcy court properly found that the Plan does not

unfairly discriminate against the Bank's unsecured deficiency claim.

IV. *Unsecured Promissory Notes*

Under the Plan, the Debtor's equity holders are to contribute $6.125 million in new capital in the form of $3.0 million in cash the day after the effective date of the Plan and $625,000 annually for five years. The five annual installments are secured by a continuing letter of credit in the amount of $1,250,000. The Bank contends that this constitutes only $4.1 million of new value in the form of money or money's worth, because the remaining $1,875,000 is not covered by the letter of credit and is therefore in the form of unsecured promissory notes. The Bank contends that the bankruptcy court erred when it considered the value of these unsecured promissory notes in determining that the interest rate to be paid on the Bank's secured claim in determining that the Plan is feasible.

The bankruptcy court found that although the notes are unsecured, there is "de facto" recourse: the partners will suffer a $20 million tax liability if the property is sold in a foreclosure sale and thus have a substantial incentive to meet their obligations under the notes, and the letter of credit securing payment of their contributions is not fully released until all five of the annual payments are made. These factors provide sufficient assurance that the payments will be made.

The Bank relies on several cases in support of its contention that unsecured promises to make future payments do not constitute money or money's worth. *See In re Snyder*, 967 F.2d 1126, 1131 (7th Cir. 1992); *In re 8315 Fourth Avenue Corp.*, 172 B.R. 725, 737 (Bankr. E.D.N.Y. 1994); *In re Yasparro*, 100 B.R. 91 (Bankr. M.D. Fla. 1989). These cases, however, all discuss whether unsecured promissory

notes can be considered in assessing the substantiality of a proposed contribution of new value for purposes of the new value exception to the absolute priority rule, which we discuss below, and not whether they can be considered for any other purpose—including determinations of feasibility or of interest rates to be paid on secured claims, as here. The Bank has not cited any cases supporting its assertion that promissory notes may not be considered in these contexts. The bankruptcy court specifically did not consider the promissory notes covering the last three annual payments in determining that the infusion of new capital is sufficient. We conclude that the court did not err as a matter of law in considering the unsecured promissory notes in determining the interest rate to be paid on the Bank's secured claim and that its factual finding that the circumstances surrounding the issuance of the unsecured promissory notes are sufficient to insure payment is not clearly erroneous.

IV. *The "New Value" Exception to the Absolute Priority Rule*

Section 1129(b)(2)(B) sets forth the minimum standards that a plan must meet to satisfy the "fair and equitable" requirement. This test, known as the "absolute priority rule," requires that unless each claim in a non-accepting class of unsecured claims is paid in full on the effective date of the plan, the plan must provide that "the holder of any claim or interest that is junior to such class will not receive or retain under the plan on account of such junior claim or interest in any property." 11 U.S.C. § 1129(b)(2)(B).

The Bank contends that the Plan violates this requirement, because, although its deficiency claim will not receive full payment, the holders of partnership interests in the Debtor—which of course are junior to the Bank's deficiency claim—do receive property in the form of equity.

The bankruptcy court found that this equity retained by the debtor's partners is on account of the new capital that they are to contribute under the Plan, and that this retention of ownership interest is permissible under a "new value" exception to the absolute priority rule.

The Bank, while conceding that the existence of the "new value" exception is an open issue in the Seventh Circuit, argues that the most persuasively reasoned Seventh Circuit discussion of the issue indicates that the court, in an appropriate case, would not recognize the exception. The Bank relies principally on *Kham & Nate's Shoes No. 2 v. First Bank*, 908 F.2d 1351, 1360-62 (7th Cir. 1990), which declined to reach the question of a new value exception because the proposed contribution by the debtor would have been insufficient in any case. The *Kham* court, nevertheless, indicated that it thought the new value exception was unlikely to survive, because the language of the Code strongly suggests that such an exception does not exist and because Congress was not receptive to a proposal by the Bankruptcy Commission to codify the exception when it recodified the bankruptcy Code in 1978. *Id.* at 1361-62.

On the other hand, the court, in *In re Snyder*, 967 F.2d 1126, 1128-31 (7th Cir. 1992), while again declining to rule on the question because of an inadequate proposed contribution, looked favorably upon the existence of the new value exception. It pointed to a strong history of the exception in judicial decisions that Congress did not clearly overrule, as well as strong policy arguments for its retention, noting in particular situations where owner participation in a reorganized entity would be particularly valuable in its operation, or where the necessary new capital would be otherwise unavailable. Furthermore, the *Snyder* court cited with approval several commentators who reasoned that the new value exception is better seen as a "corollary" to the

absolute priority rule rather than an "exception" to it. In particular, the rule bars old equity from retaining or receiving an interest "on account of" its prior ownership. But when necessary new capital is provided, the source of the retained interest is not the prior equity interest, but rather the new contribution. Thus, such a "corollary," not being an exception, survived the 1978 re-enactment of the Code. *Id.* at 1130.

More recently, the Ninth Circuit, after a long and detailed examination, held that the new value exception is valid. *In re Bonner Mall Partnership*, 2 F.3d 899, 905-17 (9th Cir. 1993). The bankruptcy court found the arguments advanced in *Bonner Mall* to be persuasive. It summarized them as follows:

> (1) the language of Section 1129(b)(2)(B) cannot unambiguously be applied in the context of a contribution of new value by the debtor's owners; (2) given this genuine ambiguity, it is appropriate to look at pre--Code practice for aid in interpretation; (3) prior to the adoption of the Code . . . the availability of the "new value" approach to reorganization was generally recognized; (4) nothing in the legislative history of the Code, or the language of the Code itself, gives any clear indication that Congress intended to eliminate the new value approach.

(Bk. Dec. at 28.) Furthermore, the Ninth Circuit found that the new value exception is consistent with the underlying policies of Chapter 11 of the Code. *Bonner Mall, supra*, at 915-17. In particular, permitting debtors to contribute new capital, which may be otherwise unavailable, increases the amount available to use in reorganization and in paying

creditors; it often allows control and management to remain with the old owners, who are often in the best position to re-establish a profitable business. Furthermore, it enhances the primary purposes of chapter 11 of successful debtor reorganization and maximization of the value of the estate *(see NLRB v. Bildisco & Bildisco,* 465 U.S. 513, 527 (1984)). *Id.* at 915-16.

The most recent Seventh Circuit case on the subject, while again declining to rule, looks favorably upon its continued vitality. *In re Wabash Valley Powers Ass'n*, 72 F.3d 1305, 1314-15 (7th Cir. 1995). The court's observation that the "common thread running through cases involving the absolute priority rule is a refusal to allow prior equity owners to trade on their 'insider' status to acquire new equity for less than its value." *Id.* at 1315. The *Bonner Mall* court, likewise, found this to be a concern and concluded that a properly applied new value exception was the best way to avoid such "insider" deals, or collusion, which are not strictly prohibited by the language of the Code. *Bonner Mall, supra,* at 916. This suggests that the "new value exception," rather than being a ministerially applied judicial appendage to the Code, is best seen as an opportunity for the bankruptcy court, in its discretion, to make use of an opportunity for new capital contributions by the debtor in fashioning a workable and equitable plan of reorganization.

In this case, the new value contributions do not result in equity holdings by the Debtor's partners that are of greater value than the contributions, the contributions do add value to the estate, and they do enhance the ability of creditors to realize their claims. Furthermore, the new capital contributions were necessary to the formulation of a successful Plan. We conclude that the bankruptcy court properly found that a new value exception does exist, and that it properly applied the exception in confirming the Plan.

VII. *Substantiality of New Capital*

The Bank argues that even if the "new value" exception continues to exist, the new capital contribution under the Plan is insufficient to satisfy the exception. The new capital contribution—$3.0 million in cash and a letter of credit posted in the face amount of $1.25 million—was determined by the bankruptcy court to have a present value of $4.1 million. This amount equals 7.5% of the Bank's secured claim and 7% of the total unsecured claims. The Bank first contends that, when considered merely as a percentage of senior claims, the new capital contribution is not substantial. *See Woodbrook, supra* at 320 (holding that a 3.8% contribution is not substantial); *Snyder, supra* at 1131 (holding that a contribution equal to 2.7% of total unsecured debt or 3.3% of the claim of a single unsecured creditor is not substantial).

The bankruptcy court responded to this argument by pointing out that the total unsecured claims are not relevant here, because many of those claims belong to the general partner or an entity that it controls and have been either waived or subordinated to the claims of the bank. Furthermore, the insider trade debt is paid in full under the Plan. Thus, the only unsecured claim that is being involuntarily primed by the new capital is the Bank's deficiency claim. The new value contribution equals about 10.7% of that claim. More importantly, the *Snyder* court itself stated that

> We cannot say that the determination as to whether an infusion of new capital is "substantial" will always hinge on a comparison to the total amount of unsecured debt. There is no mathematical formula for resolving the substantiality issue, and it will depend on the circumstances of the individual case.

Id. at 1131-32. The bankruptcy court concluded that, in this case, the new capital contribution is substantial both in absolute terms and in its impact on this case:

> The $4.1 million minimum value of the contribution in this case dwarfs the $30,000 involved in *Snyder* and the $100,000 in *Woodbrook*. It constitutes over 20% of the tax liability the partners hope to avoid. And, most significantly, the total contribution package, however valued, is substantial enough to make possible a commercial loan on the debtor's property consistent with the terms of the proposed plan. That plan, in turn, offers a substantial (16%) return on the bank's deficiency claim. The new value contributions proposed by the September 11 plan are not mere tokens, but genuine contributions to the proposed plan.

(Bk. Dec. 30-31)

The Bank contends, however, that the true measure of the substantiality of new capital contribution is whether it makes a plan feasible. *See, e.g., Woodbrook, supra,* at 320; *Snyder, supra*, at 1131 ("The substantiality requirement" means "that an infusion of new capital must be necessary to the success of the undertaking."). It then contends that the proposed new capital contribution in this case is insufficient to render the Plan feasible, because it does not sufficiently counter the projected net cash flow shortfalls in years 2002 and 2003. On the contrary, the bankruptcy court was well aware of the shortfalls in years 2002 and 2003 and of the various devices in the Plan that make the success of the Plan very likely. *See* our discussion of the Discretionary Cash Flow Readvance, *infra*. The determination of whether new capital contributions are sufficient to satisfy the exception to

the absolute priority rule is a factual one, depending on all the circumstances of the case. *See Woodbrook, supra*, at 320; *Snyder, supra,* at 1131. The bankruptcy court has thoroughly considered the circumstances of this case in determining that the new capital contribution is sufficient. We conclude that its finding is not clearly erroneous.

VIII. *Discretionary Cash Flow Readvance*

The bankruptcy court found that, due to anticipated expenses in connection with the renewal of the lease of the Debtor's largest tenant, the projected cash flow in year seven would not be sufficient to make the required debt service, and that this situation continues in year eight, though to a much smaller extent. In the ninth and tenth years, projected cash flow would once again substantially exceed the amount needed for debt service. This cash flow shortfall would be funded by the Debtor's request that the Bank relend the necessary moneys from the amounts it will have received during years one through six in the form of excess amortization payments, i.e., payments to the Bank from excess cash flow over and above the regular monthly amortization payments. The Bank contends that because this readvance feature is wholly discretionary with the Bank, the necessity of this readvance renders the Plan infeasible.

The bankruptcy court concluded that the Debtor's inability to force a loan from the bank does not imply failure of the Plan. Rather, the court found that it likely that the Bank would make the loan willingly, because

> [t]he bank would have enjoyed six years of successful operation of the property, and would, at the time of the request for relending, have a debtor with stable income prospects and a defined short term cash flow shortage. Not only would

the bank be given a generous return on the short term lending, the ultimate effect of the lending would be to increase the debtor's equity in the property, which equity would inure completely to the bank through participation interest and payment of its unsecured deficiency claim.

Alternatively, the debtor would have the option of selling the property and prepaying the loan without penalty. The experts of each party testified to an improving market for office buildings in the Chicago central business district.

Finally, if the anticipated cash shortfall in the seventh year of the plan cannot be made up by the debtor, there will still be no 'liquidation, or the need for further financial reorganization of the debtor.' The debtor's plan itself provides for a consensual transfer of the property to the bank in the event of default, and, this feature of the plan is likely to be enforced in any subsequent bankruptcy proceeding.

(Bk. Dec. at 41-42.)

The Bank contends that the bankruptcy court's finding that the Bank would make the loan willingly is clearly erroneous because it overlooked several material circumstances that the Bank contends are more likely to be relevant at that time: (1) the Rudnick & Wolfe lease extension will have only several years remaining, and thus the property will face a significant tenant rollover risk; (2) the court's prediction as to the future real estate market in general and as to the Property in particular may prove incorrect, and (3) the Debtor's past history of intentional failure to pay real estate

taxes is indicative of possible future behavior prior to impending maturity of the loan extension.

The feasibility requirement of section 1129(a)(11) is that "[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan." Thus, the "standard is whether the plan offers a reasonable assurance of success. Success need not be guaranteed." *Kane v. Johns-Manville Corp.*, 843 F.2d 636, 649 (2d Cir.), *cert. denied*, 488 U.S. 868 (1988). Furthermore,

> [a] plan meets this feasibility standard if the plan offers a reasonable prospect of success and is workable. The prospect of financial uncertainty does not defeat plan confirmation on feasibility grounds since a guarantee of the future is not required. The mere potential for failure of the plan is insufficient to disprove feasibility.

In re Patrician St. Joseph Partners Ltd. Partnership, 169 B.R. 669, 674 (D. Ariz. 1994) (citations omitted). The bankruptcy court relied on these standards in concluding that the debtor had established the feasibility of the Plan.

The Bank's objections, while reasonable, are primarily hypothetical, and constitute merely disagreements with the inferences drawn by the bankruptcy court. Furthermore, by the seventh year, the principal balance of the Bank's secured loan will have fallen to about $41.5 million, while the value of the Property is projected to have increased to considerably more than the present $55.8 million. This would permit a sale or refinancing for an amount more than enough to pay the Bank's secured claim in full. The Debtor also points out

that, (1) even in the cash flow shortfall years, net operating income will still exceed debt service on the Bank's secured loan, making default a remote possibility; (2) even in the event of a default, the Bank would automatically obtain title to the Property; (3) the Bank's apparent indisposition to make future readvances ignores the acknowledgements of its own counsel that the Bank would be subject to the duty of good faith in considering the requests; and (4) the Rudnick & Wolfe lease does not expire until 2007, five years after the cash flow shortfall years, greatly minimizing the fears of a rollover risk in 2002.

We conclude that, though there might be room for a difference of opinion, the bankruptcy court's finding that the discretionary nature of the relending feature of the Plan does not render the Plan infeasible is not clearly erroneous.

IX. *Property Conveyance Features*

The Bank contends that the bankruptcy court erred when it concluded that the Plan's provision for a consensual conveyance of the Property to the Bank in the event of a default negates any feasibility concerns because of the possibility of a Chapter 11 case being filed before the Debtor goes into a default. Though this might not normally be a negligible concern, it is greatly minimized in this case, because, as set forth in section 5.3(b) of the Plan, Mark W. Wilkow, one of the Debtor's principals, covenants to pay the Bank $10 million personally if he causes the Debtor to file a voluntary bankruptcy petition that blocks the transfer of the Property to the Bank.

The Bank also expresses doubt as to the enforceability of such a conveyance provision. It cites no cases indicating that such a provision might not be enforceable. On the contrary, at least one such conveyance provision has been upheld on

appeal. *In re Billy Ray Eubanks*, No. CIV A 89-3426, 1990 WL 128208 (E.D. La. Aug. 28, 1990) (holding that a plan that provides for the transfer of the debtor's assets to a court-appointed receiver for liquidation and distribution of assets in the event of default makes the plan feasible for the purposes of section 1129(a)(11)). We conclude that the bankruptcy court's finding that the property conveyance features of the Plan make the Plan feasible is not clearly erroneous.

X. *Concrete Plan for Sale*

The Bank contends that in the absence of a concrete proposal for a sale or refinancing of the Property during the term of the Plan, the bankruptcy court abused its discretion in finding that the Debtor would be able to sell or refinance in either year seven or ten, in order to pay the Bank's claim. The only support for this contention cited by the Bank is *In re 8th Street Village Limited Partnership*, 88 B.R. 853, 858 (Bankr. N.D. Ill. 1988). In that case, the debtor, which owned as its sole asset a shopping mall in Boise, Idaho, proposed a plan that included the sale or refinance of the mall in nine years. The court found that without a concrete plan for such sale or refinance, the plan was not feasible. However, the circumstances in that case differed significantly from the instant case. The operations of the mall were unable to generate sufficient income to service current debt, and there were no realistic prospects of a turnaround. In addition, the principal office tenant was about to vacate. The debtor's plans for improvement of its operations were found by the court to be speculative, and the testimony of its expert witness as to an improving market was not found credible. In short, the court concluded that increased competition would most likely make the debtor's projection of a turnaround little more than "hopes and dreams." In those circumstances, the court reasonably concluded that concrete

proposals for a sale or refinance of the mall would be required for confirmation of the plan. *Id.*

In the instant case, to the contrary, the income from the Property is sufficient to service current debt, with the exception of the cash flow shortfall in years seven and eight—already adequately dealt with; the vacancy rate is extremely low and is not expected to be a serious concern; and credible expert testimony on both sides supports an improving market for buildings such as the Property. In these circumstances, we conclude that the bankruptcy court properly found that the intention to sell or refinance the Property in seven or ten years, even without a concrete current proposal, is sufficient to make the Plan feasible.

XI. *GECC Letter of Intent*

Once the amount of the Bank's secured claim was fixed, it was necessary that the Bank be compensated for not receiving the full amount of its claim on the effective date of the plan by receiving a market rate of interest on its claim. Section 1129(b)(2)(A); *In re James Wilson Assocs.*, 965 F.2d 160, 172 (7th Cir. 1992); *In re Bryson Properties, XVIII*, 961 F.2d 496, 500-01 (4th Cir. 1992). The bankruptcy court found that an appropriate market rate of return must be at least the discount rate. (Bk. Dec. at 13-16.) In determining whether the Plan provided for a market rate of return, the court noted that the compensation offered to the Bank is not a flat interest rate. Instead, it consists of three elements: a loan origination fee of between $266,975 and $545,000; fixed base interest at 3.5% over the rate earned by treasury obligations maturing seven years from the effective date of the Plan; and a 50% participation in the net proceeds of any sale or refinancing. These allow the Bank a total rate of return on its secured claim of about 12%. (Bk. Dec. at 17-18.)

The bankruptcy court found convincing evidence presented by the Debtor that this transaction is acceptable in the market. Robert Walter, a regional vice-president of General Electric Capital Corporation ("GECC") prepared a letter of intent outlining the terms under which GECC would consider financing the Property.[5] With one exception, the terms of the letter of intent are the same, or more favorable to the Debtor, than the terms of the new note proposed in the Plan.[6] The bankruptcy court accepted Walter's testimony and concluded that the Plan does provide a market rate of return to the Bank on its secured claim.

The Bank offers five reasons why the GECC letter of intent should not be accepted as adequate evidence of a market rate of return: (1) the letter of intent was not a binding commitment, though Mr. Walter testified that he thought that it would receive senior management approval; it had not yet gone through the review process; (2) GECC had

---

[5] The Debtor did not pursue a commitment from GECC, because the Bank indicated it would not accept a cash payment of its secured claim in the amount found by the bankruptcy court, and furthermore, if the Debtor had proposed such a cash out, the Bank would have had the option of having its entire claim treated as secured under § 1111(b).

[6] The one exception is that the GECC letter of intent calls for a flat 1% loan origination fee—$533,950, while the Plan calls for a fee of $266,975, or such greater amount as the court may determine up to 1% of the Bank's secured claim—$545,000. The reason for the smaller fee in the Plan is that the Bank, as a current lender to the Property, would not need to engage in such an extensive due diligence as GECC would. Moreover, even with the reduced origination fee, the Plan still provides a greater overall return to the Bank than the GECC letter of intent would provide to GECC.

not made other comparable loans in the Chicago central business district; (3) GECC is not a dominant player in the real estate debt market; (4) certain of the Debtor's affiliates have enjoyed a previous association with GECC on the strength of four prior and one pending transaction; and (5) other players in the market are looking for 15-25% returns.

The bankruptcy court found, to the contrary, that GECC is indeed a major lender to single asset real estate projects and has expertise bearing precisely on issues relevant to a market rate of return on the note proposed in the Plan. Furthermore, the court found that the rates of 15-25% rates of return sought by the players referred to by the Bank's expert were on properties subject to much greater cash flow risk than is the Property. Though the court did not specifically address the remaining objections in its decision, it was well aware of them and nevertheless found, after considering testimony from experts for both sides, that the Plan provides a market rate of interest to the Bank on its secured claim. We conclude that this finding is not clearly erroneous.

XII. *Deferred Participation Interest*

The Bank contends that its being made to wait until after the Property is sold or refinanced to receive its participation interest constitutes negative amortization. It asserts, without elaboration, that such treatment is impermissible under the circumstances. The Bank provides no reasons why such treatment is impermissible other than citation to a case, *In re 641 Assocs., Ltd.*, 140 B.R. 619, 613 (Bankr. E.D. Pa. 1992), which merely noted that use of negative amortization had been permitted in rather few instances. On the contrary, the bankruptcy court found that the participation interest feature in the Plan does not constitute negative amortization, accepting testimony to that effect by Mr. Walter, who had

included a similar feature in the GECC letter of intent. We conclude that the bankruptcy court's finding is not clearly erroneous, particularly in view of the Bank's failure to provide any reasoning why such a finding should be considered incorrect.

XIII. *Deduction of Disposition Costs*

Since the bank did not elect, pursuant to section 1111(b), to have its total claim treated as secured, its claim must be bifurcated under section 506(a). Thus, the Bank's secured claim is equal to the value of its interest in the collateral. In determining the value of the Bank's collateral, the bankruptcy court reduced the gross reversionary value by the costs the Bank would incur in converting its interest to cash. The Bank does not object to the amount of such disposition costs as found by the court, but asserts that as a matter of law, it is improper to consider such costs in determining the value of the property.

The relevant statutory language is:

> An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property . . . .

Section 506(a). The bankruptcy court noted that courts initially relied primarily on the first sentence of section 506(a)

and held that disposition costs should routinely be deducted in arriving at a value for secured property because the creditor would ordinarily obtain the value of its interest only after a wholesale transaction or foreclosure sale. (Bk. Dec. at 11.) Later courts, however, placed more emphasis on the second sentence, and held that valuation depends on the debtor's plans for use or disposition of the collateral. Thus, unless the debtor plans to liquidate the collateral, it should be valued at its retail, or replacement, value rather than its wholesale or foreclosure value. *See, e.g., In re Rash,* 62 F.3d 685, 685-87 (5th Cir. 1995), *reh'g en banc granted,* 68 F.3d 113 (1995); *In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d 72 (1st Cir. 1995); *In re Trimble*, 50 F.3d 530 (8th Cir. 1995). As a matter of fact. these three cases cited in support of the Bank's position did not consider the issue of disposition costs as such, but were concerned with whether retail or wholesale value is the proper measure, the difference between which involves much more than merely disposition costs. Only *Trimble* mentions "costs of sale" explicitly. *Trimble, supra* at 531.

The bankruptcy court was not persuaded that the view espoused by these cases is the best reading of section 506(a). It followed the view of the dissent in *Rash,* which argued that in order to give effect to all the statutory language, the value of the secured claim should be measured—as required by the first sentence of section 506(a)—by the extent of the "creditor's interest" in the collateral. Unless the creditor can use the collateral in an ongoing concern, its interest is measured by what it can realize when reducing the property to cash. In this case, the creditor is a bank—it would not operate the Property as an owner. Indeed, the Bank has already stated its firm intention to foreclose. As the bankruptcy court realized, there is no reason to suppose the bank would not be able to sell the property for its fair market value. Thus it is entitled to retail value, as required by *Rash,*

Trimble, and *Winthrop, supra*, rather than wholesale or forced foreclosure value. However, in order to realize the fair market value, the Bank would incur disposition costs, and the court took those into account in valuing the property.

Because the decision in *Rash* is currently scheduled for *en banc* rehearing, and because the reasoning of both *Trimble* and *Winthrop* have been rejected by more recent bankruptcy decisions, *see In re Madison,* 186 B.R. 182 (Bankr. E.D. Pa. 1995) (valuing collateral to be retained and used by debtor at average of wholesale and retail value); *In re Hoskins,* 183 B.R. 166 (Bankr. S.D. Ind. 1995) (same), the issue of how to value collateral retained by a debtor is clearly not settled. Our review of the relevant cases leads us to agree with the conclusion of the bankruptcy court that subtracting disposition costs from the fair market value in arriving at a valuation for the Bank's interest in the Property is consistent with the language of section 506(a) and is not inconsistent with the concerns underlying the decisions in *Rash, Trimble,* and *Winthrop, supra.*

XIV. *The "Best Interests" Test*

The Bank contends that the Plan does not satisfy the "best interests" test of section 1129(a)(7) with respect to dissenting class 4 claims. Section 1129(a)(7) provides that if the holder of a claim impaired under a plan of reorganization has not accepted the plan, then such holder must "receive . . . on account of such claim . . . property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive . . . if the debtor were liquidated under chapter 7 . . . on such date." The Bank does not contest that its deficiency claim meets this test, because it would receive nothing on account of that claim in a chapter 7 liquidation. The Bank also has trade claims in class 4, however, which are to be paid in full under the Plan *without*

interest. The Bank contends that under a chapter 7 liquidation, these claims would be paid in full *with* interest from several sources, including cash on hand and/or from the resources of the Debtor's general partners pursuant to section 723.

The order of distribution of a debtor's property under a chapter 7 liquidation is governed by section 726, which distinguishes the "payment of claims" (section 726(a)(l)–(4)) from the "payment of interest . . . on any claim paid under paragraph (1), (2), (3), or (4) of this subsection" (section 726(a)(5)). Section 726(a) provides that in the event of a deficiency of property of a partnership "to pay in full all claims which are allowed in a case under this chapter," the trustee shall have a claim against a "general partner to the extent that under applicable nonbankruptcy law such general partner is personally liable for such deficiency." The bankruptcy court found that the plain meaning of this provision affords the trustee a claim against a general partner only for payment of a claim, not interest on the claim. The Bank cites only *In re Gramercy Twins Associates,* 187 B.R. 112, 125 (Bankr. S.D.N.Y. 1995) in support of its contention that the requirement of section 723(a) for the payment in full of all claims includes interest on those claims pursuant to 726(a)(5). The *Gramercy Twins* court summarizes at some length the assertions of the objecting creditor, including, among many others, the assertion that payment in full under section 723 includes interest. The court did not discuss that assertion however, because it concluded that the "best interests" test was not met in the plan before it on other, more substantial, grounds.

The Bank has not cited any decisions contrary to the bankruptcy court's interpretation of "claims" in section 723(a), nor has our research revealed any. Although we are not persuaded that the language of section 723(a) is as plain

as the bankruptcy court thought, we do agree that the clear distinction drawn by section 726(a) between "claims" and "interest" on claims makes it most likely that the reference to "claims" in section 723(a) does not include interest. We therefore conclude that the bankruptcy court correctly found that the Plan satisfies the "best interests" test.

We return to the Bank's concerns that it is not treated fairly. The gist of the Bank's position seems to be that it is an innocent party—the lender of funds that enabled the Debtor to invest in an office building, or more accurately, fifteen floors of an office building. The Debtor, or its partners, made a bad investment, because the Property lost value as a result of a downturn in the real estate market, and they stand to lose $20 million in taxes as a result. The Bank has also suffered a loss in the form of decreased value in the collateral for its nonrecourse loan. The Bank contends that it should be allowed to foreclose on the Property and take out whatever value is left in the building, while the Debtor's partners should be made to accept their tax loss—after all, they are the ones that made the bad investment. To be made to continue a relationship with the Debtor, at a risk greater than it would like, and not have its money made available to it now, so that the Debtor's partners can avoid their tax loss, is simply unfair.

The Bank's argument is an appealing one. But the reality of the situation is not so simple. The Bank argues throughout that it is not even the Debtor that wants to avoid a tax loss, but its partners, as if that somehow makes the situation even more egregious. But that is no more than an artifact of the tax code—all tax consequences of a partnership fall on its partners. Furthermore, as we have discussed above, a desire to avoid adverse tax consequences is a perfectly valid reason to seek protection under the Bankruptcy Code. Yes, the Debtor's partners made a bad investment.

But so did the Bank. Its lending of funds to purchase real estate is just as much an investment as the Debtor's purchase. Surely, the Bank thoroughly investigated the real estate market in general, as well as all relevant aspects of the Property, before making the loan. As it turned out, the downturn in the market was unforeseen. Whether it should have been foreseen we will not speculate. The fact is, neither party—both sophisticated players in their fields—did foresee it. The loss in value of the Property was not due to poor management or unsound business practices. All indications are that the Property itself is a prime piece of real estate and has been managed in an exemplary fashion. The loss was due to factors entirely beyond the control of either Debtor or Bank. Now the Bank wishes to cash out and let the Debtor (or its partners) sink.

The chief obstacle for the Bank is the Bankruptcy Code. Unless it can defeat the decision by the bankruptcy court to confirm the Debtor's Plan, it will not be able to cash out—at least not yet. The better view is to realize that chapter 11 reorganization is a collective remedy, designed to find the optimum solution for all parties connected with a business—not solely the for business itself, and not solely for its creditors. Without the Debtor's Plan, the Debtor's partners will surely take a bath. With the Plan, the prospects of the Bank's taking a bath are remote, perhaps a little greater than otherwise, but not much, and in fact, the Bank—though it asserts it does not want the Plan—stands to gain more than it would through a foreclosure now. What would the Bank do with the proceeds of an immediate foreclosure? Undoubtedly, it would lend the money in the form of mortgages not very different from the loan it now has—and is forced to continue to have—with the Debtor. Its income would be roughly the same. So it has not lost much, if anything. The Bank counters that it is made to bear a greater risk than it would like. Perhaps. But, the Debtor has chosen

to seek protection against a much more certain loss—as it is entitled to under the Bankruptcy Code—and the bankruptcy court has determined, after a thorough examination of the relationship and the factors that impinge on its future, that the Bank's risk, under the confirmed Plan, is little different from what it would be in a more normal lending relationship. So much is true if the Plan is a workable one. That brings us to the second part of our summary.

In order for a plan to be confirmed, it must meet all of a rather large number of conditions that are set forth in section 1129. These conditions are designed not only to insure that a plan will work, but that it meets minimum standards of fairness for all participants. The Bank has challenged the bankruptcy court's order confirming the Plan on the basis of most of these conditions, and most of the Bank's objections are credible. That is perhaps not surprising. Any debtor in bankruptcy will have limited resources and will accordingly find it difficult to meet all of the conditions of section 1129. If a debtor could easily meet all of them, it probably has sufficient resources that it need not have filed a petition under chapter 11. Nevertheless, plans of reorganization are often confirmed. As is clear from our examination above of the many decisions challenged by the Bank, bankruptcy courts are given a great deal of discretion in determining whether or not to confirm a plan. All that is required is that the conditions of section 1129 are reasonably met and that the plan has a reasonable likelihood of success. Our review of this Plan leaves us with the clear overall impression that, even though one may reasonably quibble with the bankruptcy court's conclusions here and there, the Plan has a high likelihood of success and is fair to all participants, even though it may not be to the Bank's liking. It is also apparent from the wealth of case law that has been asserted in this appeal that those plans that are not confirmed, or whose confirmation is reversed on appeal, are

overwhelmingly plans that very obviously will not work. That is not true of this Plan. Therefore, we affirm the bankruptcy court.

Appeal of Denial of Relief from Stay and Conversion

The Bank also appeals from the bankruptcy court's denial of its motion for relief from the automatic stay pursuant to section 362(d) and its motion to convert the Debtor's chapter 11 case to a case under chapter 7, or in the alternative, to dismiss the chapter 11 case pursuant to section 1112(b). Its only argument is that reversal of the Confirmation Order requires reversal of the denials of the two motions. Because we affirm the Confirmation Order, we also affirm the bankruptcy court's denial of the Bank's motion for relief from stay and of its motion for conversion or dismissal.

Conclusion

For the reasons set forth above, the Debtor's motion to dismiss the Bank's appeal as moot is denied; the bankruptcy court's order confirming the Debtor's second Amended Plan of Reorganization Dated September 11, 1995 as modified is affirmed; and the bankruptcy court's orders denying the Bank's motion for relief from the automatic stay and denying the Bank's motion for conversion are affirmed.

ENTER:

/s/ Paul Plunkett
UNITED STATES DISTRICT JUDGE

DATED: April 30, 1996

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

BANK OF AMERICA ILLINOIS,
Appellant,

vs.

203 NORTH LASALLE STREET PARTNERSHIP,
Appellee.

JUDGMENT IN A CIVIL CASE

CASE NUMBER:
96 C 0238 (95 B 4998)

☐ Jury Verdict. This action came before the Court for a trial by jury. The issues have been tried and the jury has rendered its verdict.

☒ Decision by Court. This action came to a hearing before the Court. The issues have been heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED the Debtor's motion to dismiss the Bank's appeal as moot is denied; the bankruptcy court's order confirming the Debtor's second Amended Plan of Reorganization Dated September 11, 1995 as modified is affirmed; and the bankruptcy court's orders denying the Bank's motion for relief from the automatic stay and denying the Bank's motion for conversion are affirmed.

April 30, 1996
Date

H. Stuart Cunningham
Clerk

(By) Deputy Clerk

APPENDIX D

UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

In re:	)	
203 North LaSalle Street Limited Partnership,	)	**Bankruptcy Case No. 95 B 4998**
Debtor.	)	

MEMORANDUM OF DECISION

This single asset Chapter 11 case is before the court for determination of whether the debtor's Second Amended Plan of Reorganization, dated September 11, 1995 (the "September 11 plan"), should be confirmed. Based on the facts adduced at the hearings on this matter, and for the reasons set forth below, the court finds that the plan generally satisfies the requirements of 11 U.S.C. § 1129 and that confirmation is appropriate, subject to a minor modification.

Jurisdiction

The confirmation of a plan of reorganization, as a proceeding that arises under the Bankruptcy Code (Title 11, U.S.C.), is within the jurisdiction of the district court pursuant to 28 U.S.C. § 1334(b). The district court may refer such proceedings to bankruptcy judges pursuant to 28 U.S.C. 157(a), and by General Rule 2.33, the District Court for the Northern District of Illinois has done so. The confirmation of a plan, pursuant to 28 U.S.C. § 157(b)(2)(L),

is a core matter as to which a bankruptcy judge may enter appropriate orders and judgments.

Findings of Fact

Background. The debtor is an Illinois limited partnership that owns fifteen floors of office space in a building in the central business district of Chicago. These floors are the upper portion of a larger building, whose lower portion is devoted to retail stores and parking. The lower portion is separately owned, with the two owners jointly responsible for maintenance. The debtor's property is encumbered by a lien in favor of Bank of America Illinois (the bank). This lien secures a nonrecourse note in the principal amount of $92,582,000. The note became due and payable, according to its terms, on January 3, 1995. The debtor was unable to pay the note at that time, and the bank commenced a state court foreclosure action on January 20. In response, the debtor filed this bankruptcy case on March 13. At the time of the filing, the bank's claim, principal and interest, was $93,013,612. Also outstanding at the time of the filing were several other, smaller claims: (a) a state property tax claim of about $2.3 million, (b) general unsecured trade debt of about $160,000, (c) unsecured insider claims of $7.7 million (of which $6.8 million is a claim of the debtor's general partner for an unsecured loan), and (d) a second mortgage held by the debtor's general partner in the amount of $11.3 million. After the filing, the debtor's general partner purchased some of the trade claims, reducing the general unsecured claims held by noninsiders to about $90,000. In addition to its real property, the debtor holds the right to a cash account, consisting of prepetition rents, that at the time of confirmation held approximately $3.1 million.

Because of the relatively straightforward financial issues of this case, and in order to avoid motions raising the

question of whether an effective reorganization was possible, the court ordered the debtor to propose its plan of reorganization within 30 days of the case filing. Accordingly, on April 13, the debtor proposed its original plan of reorganization, subsequently amended on May 12. To expedite the proceedings further, the court conditionally approved a disclosure statement for the May 12 plan, and, with the consent of the parties, considered the adequacy of the statement, together with plan confirmation, at a single hearing. See A. Thomas Small, "Small Business Chapter 11 and Chapter 11A Cases," Education Program Materials, 67th Annual Meeting of the National Conference of Bankruptcy Judges, Orlando, Florida, Oct. 17-20, 1993, p. 1-23, for a description of this procedure. The court held a hearing and received briefs from the parties in June, and, on August 7, denied confirmation of the plan. The principal ground for the ruling was unfeasibility: the minimum interest rate that the court found to be required for payment of the bank's secured claim could not be supported by the projected cash flow of the property. However, because the question of the appropriate interest rate was an unsettled legal issue, the court allowed the debtor an opportunity to amend its plan.

After a number of revisions, the debtor ultimately proposed the pending plan, dated September 11, and the court again conditionally approved a disclosure statement for the plan. On October 20, following notice and an opportunity for creditors to change their votes, the court conducted a second combined hearing on adequacy of disclosure and confirmation. At this hearing, there was no objection to the adequacy of the disclosure statement, and it was agreed that evidence taken in the first confirmation hearing would be considered in connection with the September 11 plan.

Property valuation. The principal factual dispute between the parties concerns the value of the property, and

the closely related question of the cash flow the property is likely to generate. Both the debtor and the bank presented expert appraisal testimony on these issues, and the experts agreed on the most appropriate valuation method: discounted cash flow. This technique—described in Leslie K. Beckhart, *No Intrinsic Value: The Failure of Traditional Real Estate Investment Methods to Value Income-Producing Property*, 66 S.Cal.L.Rev. 2251, 2285-2288 (1993)—operates basically in three steps. First, the appraiser estimates the cash flow that the property will generate each year of a several year holding period. Next, the appraiser determines the "reversionary" value of the property, at the end of the period, by capitalizing a stabilized income that the property is estimated to then produce. Finally, using an appropriate discount rate, the appraiser reduces the values derived in the first two steps to present values, and totals these values to arrive at the value of the property. See American Institute of Real Estate Appraisers, *The Appraisal of Real Estate* 487-518 (9th ed. 1987), for a fuller discussion of this method of valuation.

The court accepts the discounted cash flow method of valuation. The Beckhart article persuasively argues for its superiority over alternative methods, and the agreement of opposing experts gives a further indication of its appropriateness. To arrive at a valuation of the property, then, it is necessary (1) to estimate net cash flows over an appropriate holding period, and (2) to determine both an appropriate capitalization rate for the reversion and an appropriate discount rate.

In the pending case, each of the appraisers chose a period of ten years for estimating annual cash flow, and then capitalized a stabilized income for the eleventh year. The appraisers differed, however, in their estimates of income and in the capitalization and discount rates they applied. The debtor's appraiser applied a higher discount rate (14.367%)

to overall higher income estimat s; the bank's appraiser used both a lower discount rate (11.75%) and lower income estimates.[1] The following table summarizes the differences in their determinations for the ten year holding period, with the debtor's valuation about $1.1 million higher than the bank's.

[1] The debtor's appraiser used a 13.5% discount rate, compounded monthly, for purposes of discounting the annual cash flows. This rate is equivalent to an APR of 14.367%, which is used here to make the comparisons consistent (all other discount figures use annual compounding).

Year Ending	Debtor's Estimated Cash Flow (in $ thousands)	Present Value (discounted at 14.367%)	Bank's Estimated Cash Flow (in $ thousands)	Present Value (discounted at 11.75%)
1996	4,085	3,572	4,334	3,878
1997	5,720	4,373	5,769	4,620
1998	5,768	3,856	2,904	2,081
1999	5,683	3,322	5,587	3,583
2000	6,933	3,543	7,195	4,129
2001	7,388	3,302	7,751	3,980
2002	1,938	757	3,438	1,580
2003	4,350	1,486	(3,446)	(1,417)
2004	7,238	2,162	6,081	2,237
2005	8,637	2,256	8,464	2,787
Total	58,285	28,628	48,077	27,457

The appraisers similarly differed in their calculation of the reversionary value, as shown below, but here the debtor's valuation was about $4.8 million less than the bank's:

	Debtor	Bank
Estimated Stabilized Income (in $ thousands)	9,143	8,340
Capitalization Rate	.10	.09
Gross Reversionary Value	91,425	92,667
Estimated Disposition Cost	2,286 (2.5%)	1,853 (2%)
Net Reversionary Value	89,140	90,814
Discount Rate	.135	.1175
Present Value	25,125	29,900

The result of these differing approaches was an estimated value of $53,750,000 by the debtor and $57,400,000 by the bank.

The court cannot accept either of these valuations. The future cash flows of the property depend primarily on the renewal of leases. The property is, at present, nearly fully leased, but two leases to major tenants will expire during the ten-year holding period. The debtor negotiated a renewal of one of these leases contingent on confirmation of its plan, and that renewal is reflected in the appraisers' estimates of future cash flow. The other major tenant, however, has not agreed to a lease renewal. If it fails to renew, the debtor may experience (1) a period of vacancy in a significant portion of its space, (2) increased commissions on rerental, and (3) increased costs of space alteration. The bank's appraiser treated this tenant's lease, for most purposes, in the same way as other, smaller tenants, estimating a 50% chance of renewal. The debtor's appraisal, on the other hand, assumed

a 100% chance of renewal of the lease, and assumed highly favorable circumstances in that renewal. This is the primary basis for the difference in estimated cash flows. The court's assessment of the situation generally lies between those of the appraisers. Given the size of the space occupied by the tenant, and the paucity of available alternative space, it is very likely that the tenant will renew its lease. However, the importance of the tenant to the debtor's operations will likely allow it concessions that will depress the debtor's cash flows under the renewed lease. Thus, the most reasonable estimation of income reflects no extraordinary loss at the time of the lease expiration, but lower income than suggested by either appraiser in the period after the renewal of the lease.

The difference between the two appraisers on capitalization and discount rates reflects their different approaches to income estimation. The debtor's appraiser took the point of view that because the cash flow projections were somewhat risky, the capitalization and discount rate should be at the high end of the spectrum of reasonable rates. The bank's appraiser took the point of view, in light of the high quality of the building (and perhaps the conservative estimation of cash flows), that the rates should be at the lower end of the spectrum. The court's view is that, when the income is properly estimated to take into consideration the most likely leasing results, the rates employed should be those of an average building of the debtor's type: in this case, a first class office building in the central business district. From the data presented by the appraisers, these average rates would be a 10% terminal capitalization rate and a 12% discount rate.

Applying the 12% discount rate to future cash flows, as found by the court, results in a present value, over the ten-year holding period, of $30.0 million, as shown below:

Year Ending	Estimated Cash Flow (in $ thousands)	Present Value (discounted at 12%)
1996	4,100	3,661
1997	5,700	4,545
1998	5,300	3,772
1999	5,700	3,621
2000	6,900	3,916
2001	7,300	3,698
2002	1,000	452
2003	3,800	1,538
2004	6,500	2,344
2005	7,700	2,479
Total	54,000	30,026

The present value of the reversion, based on stabilized income in the eleventh year of $8.2 million, capitalized at 10%, and discounted at 12%, is $25.8 million, calculated as shown below:

Estimated Stabilized Income (in $ thousands)	8,200
Capitalization Rate	.10
Gross Reversionary Value	82,000
Estimated Disposition Cost	1,845 (2.25%)
Net Reversionary Value	80,155
Discount Rate	.12
Present Value	25,806

The total value of the property, then, as of the time of the confirmation hearing, was $55.8 million.

The debtor's plan. The major features of the debtor's September 11 plan, relevant to the present decision, are the following:

(1) The debtor's partners would contribute a total of $6.125 million in new capital to the debtor over the life of the plan, $3 million on the day after the effective date of the plan, and $625,000 on each of the next five anniversaries of the effective date. The payment of the five annual installments would be secured by a continuing letter of credit in the amount of $1,250,000.

(2) Priority and tax claims would be paid in full, within 30 days of the effective date of the plan, from funds currently on deposit.

(3) The trade creditors would be paid in full, without interest, 180 days after the effective date of the plan. Upon confirmation, the insiders would waive the general unsecured claims that they hold (including, apparently, the claims purchased by the general partner).

(4) The bank's secured claim, fixed at $54,544,500, would be paid partly in cash ($1,149,500 within five days of the effective date of the plan), and partly through an interest bearing note, secured by the bank's lien on the property. Monthly payments would be made on the note, on a thirty-year amortization schedule, and the note would mature in seven years, extendable to ten years at the debtor's option, upon certain conditions. The principal of the note would further be reduced by monthly payments to the bank of the excess cash flow of the property. The note would compensate the bank for its extension of credit in three ways; first, a commitment fee in an amount between $266,975 and $545,000, to be determined by the court; second, fixed "base interest" at a rate 3-1/2 per cent over the rate of U.S. Treasury obligations maturing 7 years after the effective date of the plan; and third, "participation interest" of 50% of the net value of the property, either as realized in a sale, or as appraised at the time of any refinancing.

(5) From the remaining value of the property at the time of sale or refinance, payments would be made in the following order: (a) on the unsecured deficiency claim of the bank, payment in full, without interest; (b) for the new capital contributions, payment in full, with interest at varying rates; (c) on the second mortgage held by the general partner, full payment with 10% simple interest; and (d) to the debtor's partners in proportion to their contributions of new capital.

(6) In the event of any default in making the new capital contributions or in making payments under the note, a deed to the debtor's property, held in escrow by a title company, is to be conveyed to the bank. The plan also has a number of features designed to minimize the possibility of any future bankruptcy filing interfering with the bank's right to obtain this conveyance.

This plan, and indeed, the entire bankruptcy case, was filed by the debtor primarily to avoid the severe tax

consequences to the debtor's partners of a foreclosure sale of the debtor's property. The principal of the general partner estimated the collective tax liability of the partners, in the event of foreclosure, at $20 million.

The general unsecured creditors in the class defined by the debtor's plan voted in favor of the plan; the only votes against confirmation were those of claims held or purchased by the bank.

Conclusions of Law

In order for a plan to be confirmed in a Chapter 11 case, the proponent of the plan must demonstrate that the requirements of Section 1129 of the Bankruptcy Code are satisfied. Although the matter has been debated, it now appears fairly well established that the burden of proof is by a preponderance of the evidence. *In re Briscoe Enters., Ltd., II*, 994 F.2d 1160, 1163-65 (5th Cir. 1993); *In re Arnold & Baker Farms*, 177 B.R. 648, 654-55 (Bankr.9th Cir. 1994); *In re Locke Mill Partners*, 178 B.R. 697, 700 (Bankr.M.D.N.C. 1995). That standard has been applied to the fact findings set forth above, and in the discussion that follows. However, even if a plan proponent were required to establish compliance with Section 1129 by clear and convincing evidence, the court's determinations would be the same.

Section 1129 operates in two parts. First, Section 1129(a) sets forth a number of requirements generally applicable to Chapter 11 plans. These include, in Section 1129(a)(8), a requirement that the plan be accepted by each impaired class of claims or interests. Second, Section 1129(b) provides that a plan complying with all of the other requirements of Section 1129(a) may be confirmed despite the failure of an impaired class to accept it, if several additional "cram down" requirements are also met. *In re Bryson Properties, XVIII*, 961 F.2d 496, 500 (4th Cir. 1992); *Hanson*

v. First Bank, 828 F.2d 1310, 1312 n.2 (8th Cir. 1987). Because the bank has not accepted the debtor's plan, both the general and cram down requirements are applicable here. The bank contends that the plan fails to meet nine of these requirements.

In considering the bank's objections, it is helpful to group them into three general categories: treatment of the secured claim, treatment of unsecured claims, and general requirements for confirmation.

A. Treatment of the bank's secured claim.

Objection 1: Section 1129(b)(2)(A).

The cram down provisions of Section 1129(b)(1) include the requirement that a plan be "fair and equitable" with respect to each nonaccepting impaired class. Section 1129(b)(2) fleshes out this requirement by defining minimum standards of fairness and equity in the treatment of the various classes of claims and interests. The minimum standards for secured claims are set out in Section 1129(b)(2)(A). Under this provision, a plan may provide for the creditor to retain the liens on its collateral and for creditor to "receive on account of [its secured] claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in [the collateral]." Under this option, the creditor must be paid the amount of its allowed secured claim together with a market rate of interest. *In re Bryson Properties, XVIII*, 961 F.2d 496, 500-01 (4th Cir. 1992) (market rate of interest provides creditor with present value of its claim); *cf. In re James Wilson Assocs.*, 965 F.2d 160, 172 (7th Cir. 1992) (indubitable equivalent of claim is provided by an interest rate that "compensates [the secured creditor] for the opportunity cost of its money and the risk of default"). The bank contends that the September 11 plan fails to meet this

requirement in two respects: first, that it undervalues the bank's claim; second, that the interest rate is below market.

Disposition costs. With respect to the amount of the secured claim, the parties agree that because the collateral supporting the bank's claim is worth less than the bank's total claim ($93,013,612), and because the bank did not make the election under Section 1111(b) of the Code to have its total claim treated as secured, there must be a bifurcation of that claim under Section 506(a). This bifurcation results in the bank having a secured claim to the extent of the value of its interest in the collateral, and an unsecured claim for the difference between the value of its interest in the collateral and its total claim. The parties further agree that, for purposes of this bifurcation, the collateral should be valued as of the time of confirmation. See *In re Addison Properties Ltd. Partnership*, 185 B.R. 766, 770-75 (Bankr.N.D.Ill. 1995), for a discussion of the process and timing of Section 506(a) bifurcation. As set out above, the court has valued the debtor's property serving as collateral for the bank's claim at $55,800,000. The disagreement between the parties—beyond the factual issue of the valuation—is over the question of whether the bank's interest in the property should be reduced by the costs that the bank would incur in converting that interest to cash. The debtor's plan estimates the bank's disposition costs at 2-1/4% of the property value ($1,255,500), and so sets the amount of the secured claim at $54,544,500. The bank raised no objection to the amount of the estimated costs, and the court finds them reasonable. However, the bank argues that it is improper as matter of law for any disposition costs to be used in valuing its interest in the debtor's property, citing, among other decisions, *In re Winthrop Old Farm Nurseries, Inc.*, 50 F.3d 72, 74 (1st Cir. 1995); *In re Trimble*, 50 F.3d 530, 532 (8th Cir. 1995); and *In re Rash*, 31 F.3d 325, 329 (5th Cir. 1994), *modified*, 62 F.3d 685, *reh'g en banc granted*, 68 F.3d 113 (1995).

The decisions cited by the bank primarily deal with the question of whether, for purposes of bifurcation under Section 506(a), the value of collateral should be viewed from the perspective of the debtor or the creditor. The relevant statutory language is the following:

> [1] An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim. [2] Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property . . . .

Initially, courts construed this language by placing primary emphasis on the first sentence of Section 506(a), which defines the secured claim as the value of the "creditor's interest" in the estate's interest in property. Because the creditor would ordinarily be able to obtain the value of its interest only in a wholesale transaction or foreclosure sale, the courts generally sought to determine what value that the creditor would obtain in such a sale. The disposition costs involved in such a sale, accordingly, were deducted. *See In re Balbus*, 933 F.2d 246, 252-53 (4th Cir. 1991) (Murnaghan, J., dissenting) (collecting authorities). Later decisions, including those cited by the bank, focused more on the second sentence of Section 506(a), which requires that the value of the secured claim be determined in light of "the proposed disposition or use" of the collateral. This language suggested to these courts that valuation should depend on what the debtor plans to do with the property, and that, unless the debtor plans a liquidation, the property should be valued at its retail or replacement cost. Under this view, the

creditor's likely disposition costs are irrelevant to the determination. *See In re Rash*, 62 F.3d at 685-87 (collecting authorities).

However, despite its adoption by a number of circuits, this "second sentence" view of Section 506(a) is not the best reading of the section. In order to give effect to all of the statutory language, the value of the secured claim should be measured—as first sentence of Section 506(a) requires—by the value of the "creditor's interest" in the estate's property, and unless the creditor has some special capacity for dealing with that property, its interest is the value that it can obtain from a sale of the property. Indeed, the Code gives the debtor the alternative of treating secured claims in cram down by selling the property and giving the creditor a claim to the net proceeds. 11 U.S.C. §§ 1129(b)(2)(A)(ii), 506(c). Next—as the second sentence of Section 506(a) states—the disposition and use of the property must be seen as having a potential influence on the value of the creditor's interest. Thus, if a debtor intends to hold damaged equipment for ultimate sale as scrap, the creditor cannot assert that it should be valued as though it were repaired and used in a going concern. And similarly, if the property is intended to be used in an ongoing business, the debtor cannot insist on a forced-sale valuation. In this way, the intended disposition or use of the property is relevant, but, as Judge Robert Parker pointed out in his dissent from denial of panel rehearing in *Rash*, now pending rehearing en banc, intended disposition or use is relevant only "to the extent that it affects the creditor's interest in the collateral." 62 F.3d at 688.

Here, the creditor is a bank, and there is no indication that, in the absence of a bankruptcy, the bank would operate the property as owner. Its interest, as creditor, is in reducing its claim against the property to cash. Taking into consideration the use of the property intended by the debtor, there is no reason to suppose that the bank would not be able

to sell the property for its fair market value, and so the bank is entitled to this value, rather than a lower value based on a foreclosure or other forced sale. However, in order to realize fair market value, the bank would have to incur disposition costs, and those costs are properly deducted in determining the value of the bank's interest in the property and, hence, the amount of its secured claim under Section 506(a). *Cf. In re Schaumburg Hotel Owner Ltd. Partnership*, 97 B.R. 943, 948-49 (Bankr.N.D.Ill. 1989), and *In re Davis*, 14 B.R. 226, 228 (Bankr.D.Me. 1981) (each valuing a claim secured by property retained by the debtor at fair market price less disposition costs).[2] The valuation of the bank's secured claim at $54,544,500 is therefore correct.

Interest. With the amount of the bank's secured claim fixed, the remaining issue under Section 1129(b)(2)(A) is the

---

[2] *Winthrop Old Farm Nurseries* expresses the fear that this interpretation of Section 506(a) will lead to inequitable results: "allow[ing] a reorganizing debtor to reap a windfall by stripping down the lien to liquidation value and quickly selling the collateral at fair market value, thus pocketing equity that would have been completely beyond reach save for the filing of the bankruptcy petition." 50 F.3d at 76. This fear is misplaced for two reasons. First, the property should be valued using whatever method of sale, commercially available to the creditor, produces the highest value. In many cases, like the present one, this will be the fair market value. A debtor, no less than its secured creditor, would incur disposition costs to obtain this value, and so there is no "quick profit" available to the debtor. Second, to the extent that the debtor is able to sell the property for more than the value of the secured claim, the resulting profit may well be directed—as in the present case—to the payment of unsecured claims, including the secured creditor's deficiency claim, rather than to the pockets of the debtor.

(continued...)

market rate of interest that properly compensates the bank for not receiving a cash payment of this claim on the effective date of the plan. In assessing this rate, a key role is played by the discount rate used to establish the fair market value of the property.

a. The minimum interest for a nonrecourse loan with a 100% loan to value ratio is the discount rate. As the bank's expert persuasively testified, it is economically impossible for a lender to make a nonrecourse loan secured only by real property that is worth no more than the amount of the loan (*i.e.*, a nonrecourse loan with a 100% loan to value ratio). The reason for this is clear from a comparison of the discount rate with an appropriate interest rate.

The discount rate, as described above, determines the price that an owner is willing to pay to receive the expected future cash flows of a particular investment. The owner discounts the future returns on the investment by a rate that reflects two different costs: (1) the cost of not consuming its cash immediately, together with the cost of inflation—what the *James Wilson* decision refers to as "the opportunity cost of its money," and (2) a risk premium, reflecting the uncertainty that the expected returns will actually be realized. Beckhart, *No Intrinsic Value, supra*, 66 So.Cal.L.Rev. at 2286; *cf.* Frank K. Reilly, *Investment Analysis and Portfolio Management* 17-25 (4th ed. 1994) (discussing components of

---

[2] (...continued)

Other decisions, *e.g.*, *In re McClurkin*, 31 F.3d 401, 405 (6th Cir. 1994), use the phrase "purely hypothetical" in determining that disposition costs should not be deducted from the value of a secured creditor's claim. Yet the entire process of claim valuation is "purely hypothetical," since it ascribes value to property without an actual sale.

rate of return). The lender's interest rate similarly compensates the lender for its "opportunity cost" and risk premium. "Opportunity costs" are the same for both an owner and a lender. Reilly, *supra,* at 21 (costs related to deferred use of money and inflation affect all investments equally). So if the risk premium for a particular investment is also same for both owner and lender, the owner's discount rate and the lender's interest rate would be identical.

This situation can easily be imagined: consider a nonrecourse loan made to finance the purchase of Treasury bills, with the bills themselves the only security for the loan, and the term of the loan equal to the bills' term to maturity. Since T-bills are assumed to be risk free, Reilly, *supra*, at 19, the risk premium for the owner of the bills and for the lender is identical—zero for each. Ignoring the transaction costs of processing and enforcing the loan, the only costs to the owner and the lender in such a transaction would be the identical "opportunity cost," and so the discount rate that the buyer would use in determining what to pay for the bills would be the same as the interest rate that the lender would demand on a loan for the purchase price. With the interest rate equal to the discount rate, the owner would pay in interest all of the anticipated earnings on the bond, and this is entirely reasonable: the owner, having put nothing at risk, would hardly be accorded any earnings; the lender, having risked the entire sum necessary to purchase the bonds, would expect all of the earnings.

If the situation is changed to one in which the risk to the lender is greater than the risk to the owner, then the interest rate must be higher than the discount rate. This is precisely the situation in regard to a nonrecourse loan for the entire value of real estate, secured only by the real estate. Even if transaction costs are again ignored, the lender has greater risk, since its return is limited to the interest specified in its agreement with the owner, while the owner has the benefit of

any greater than anticipated cash flows. *Cf. Dacon Bolingbrook Assocs. v. Fed. Nat'l Mortgage Ass'n,* 155 B.R. 467, 470 n.12 (N.D.Ill. 1993) (noting that second mortgage holder has greater risk than owner of equity). Accordingly, a market-based, nonrecourse loan for the entire value of real property is the economic equivalent of a flying pig: it does not and cannot exist. To compensate the lender properly for the increased risk it bears, the interest rate on such a loan would have to be higher than the discount rate used by the owner in valuing the property, and this would require a return to the lender of more than the anticipated cash flow of the property. In this way, financial theory corroborates common sense: even more than in the situation of T-bills, an owner who invests no money in the purchase of real property, and assumes no liability, will not, in the market, receive any return on its "investment."

This situation would not change simply because two lenders were involved instead of one. The debtor's expert testified, without contradiction, that a commercial lender would be willing to make a ten-year nonrecourse first mortgage loan of 70% of the value of the debtor's property with a risk premium rate of 2% over the rate of Treasury issues with a comparable maturity (then about 6%), for a total interest rate of 8%. It is reasonable that such a loan would bear an interest rate less than the discount rate, because the risk that the lender will not receive its expected earnings is substantially reduced by the 30% equity cushion. However, any second-mortgage lender in such a situation would require a rate of interest on a loan of the remaining 30% of the property value much greater than the discount rate, and the blended interest rate on the two loans would exceed the discount rate.

For an illustration of this process, consider the situation suggested by the debtor's expert: a nonrecourse first mortgage loan of 70% of the value of real property, at 8% interest,

where the property is valued using a 12% discount rate. For purposes of illustration, assume that the property is worth $1000; the loan would then be $700, and the owner's investment would be $300. If the property performs as expected, 12% of its value annually (on average), or $120 will be generated in net cash flow. Of this cash flow, 8% of the $700 loan—$56—would annually be expended in interest on the loan. The owner would then receive the remaining cash flow—$64—as a return on its investment of $300. That is an annual return to the owner of 21.3% ($64/300). The owner receives this return, higher than the discount rate, because its risk is leveraged: the first mortgage lender receives nearly half of the income of the property before the owner receives anything. A second lender who took the debtor's position in this situation would similarly have leveraged risk, but its risk would again be greater than the owner's, because of its inability to obtain greater than anticipated cash flows. Thus, the lender would require, for a market rate of interest, more than the owner's leveraged anticipated rate of return, or, in this illustration, more than 21.3%.

There are decisions that attempt to arrive at a hypothetical market rate for cram down of the undersecured portion of a secured claim by similarly splitting the claim into two separate portions: a 70-75% portion that can be financed at a commercial rate, and a 25-30% portion that is financed at a hypothetical "second-mortgage" or "equity" lending rate. The rates attributable to the two loans are then blended. See the "band of investment" technique employed in *In re Bloomingdale Partners*, 155 B.R. 961, 984-85 (Bankr.N.D.Ill. 1993), and *In re SM 104 Ltd.*, 160 B.R. 202, 233-34 (Bankr.S.D.Fla. 1993). If the second-mortgage loan in the band of investment technique is accorded a properly leveraged interest rate, this technique will similarly result in the conclusion that a nonrecourse loan for 100% of the value

of real property is not possible, because the blended interest rate will be greater than the discount rate.

It was largely on this basis that the court denied confirmation of the debtor's initial plan. The proposed interest rate was below the discount rate, and payment of interest at greater than the discount rate would be impossible, requiring expenditure of more than all of the property's anticipated cash flow.

b. The debtor's present plan provides for payment of a market rate of interest. From the foregoing discussion of discount and interest rate, it is apparent that, for cram down of an undersecured claim in a single asset real estate case, the secured creditor must be given something of value to reduce the risk that it faces in extending financing of 100% of the value of its secured claim, without recourse. The debtor's September 11 plan, now before the court, reduces the risk to the secured creditor of payment on its secured claim in several respects, as compared to simple nonrecourse financing of the entire property value.

- The debtor would use newly contributed funds, now on deposit, to make an immediate cash payment of $1,149,500 on the secured claim. Thus, the proposed new note to the bank would be in the principal amount of $53,395,000, about 98% of the value of the bank's interest in the property.

- The debtor proposes to use additional funds now on deposit ($1,850,500), and five future annual contributions of $625,000 to add to the debtor's operating funds. The first two of these payments (totaling $1,250,000) are secured by a letter of credit; discounting these two payments at 8% (considering the reduced risk involved with the letter of credit) produces a present value of $1,114,500. These additional funds reduce the risk to the bank that any shortage in anticipated cash flows will result in the debtor's inability

to repay the loan. Moreover, the notes documenting the partners' obligation to make their annual contributions are collateral for the new note to the bank. If the present value of all of the money to be contributed by the partners, either now on deposit or secured by the letter of credit, $4,114,500, is counted as "value" to the bank, the loan to value ratio for the proposed new note drops to about 93%.

• Although the new bank note is nonrecourse, the partners are liable to the extent of their promissory notes for annual contributions, and apart from these notes, there is "de facto" recourse. As noted above, the partners will suffer a collective $20 million dollar tax liability if the debtor's property is sold in a foreclosure sale. They have a substantial incentive, therefore, to make their additional contributions to the partnership to assure that the partnership meets its obligations under the new note to the bank. Moreover, the letter of credit securing payment of the partners' contributions is not fully released until all five of the $625,000 annual payments are made. These factors combine to give some assurance that even the three payments not initially secured by the letter of credit will be made. It is difficult to value these last contributions for collateral purposes, since payment would depend on the future financial situation of the individual partners, a question not fully explored at the hearing. However, even if the last three payments are discounted at 18%, indicating a quite high risk of nonpayment, they would still provide present value of about $976,000, reducing the loan to value ratio for the proposed new note to about 91%.

The compensation offered to the bank under the proposed new note is not a flat interest rate. Rather, as described above, it consists of three separate elements: a loan origination fee of between $266,975 and $545,000, fixed base interest (at 3.5% over the rate earned by Treasury obligations maturing 7 years from the effective date of the plan), and a

50% participation in the net proceeds of any sale or refinancing. Using the cash flow projections set forth in the findings of fact, assuming that the debtor's partners make all of the contributions provided for by the plan, and fixing the origination fee at $266,975, these provisions would allow the bank a total ("all-in") rate of return of about 12% on its secured claim. The debtor can propose this compensation to the bank, at a rate that approximates the discount rate used to value the property, for two reasons: first, there is the contribution of new capital, which allows the amount financed to be less than the value of the property; second, a portion of the compensation is not paid until sale or refinance, and it is based on an anticipated appreciation of the property. Whether this is a market rate of return (*i.e.*, a rate that adequately compensates the bank for its "opportunity cost" and the risk of nonpayment), depends on how, in the market, a lender would view the entire transaction proposed by the debtor.

The debtor presented convincing evidence that the transaction is acceptable in the market. Robert Walter, a regional vice president of General Electric Capital Corporation ("GE Capital"), prepared a letter of intent, outlining the terms on which GE Capital would consider financing the debtor's property. In all but one respect, discussed below, the terms of the letter of intent are the same, or more favorable to the debtor, than the terms of the new note proposed by the September 11 plan. The most significant difference between the letter of intent and the proposed new note is that the letter of intent, unlike the note, reduces the net proceeds subject to lender participation by the amount of new capital contributed, and allows the partners a 9% equity return on their new capital before net cash flows are paid to reduce the loan principal. As a result of these differences, among others, the all-in rate of return under the letter of intent is significantly less than under the plan:

10.64% as calculated by the bank's expert; 11.28%, as calculated by the debtor.[3]

The debtor did not pursue a commitment from GE Capital because the bank indicated that it would not agree to a cash payment of its secured claim in the amount found by the court, and the bank would have had the option of having its entire claim treated as secured if the debtor proposed such a cash out, pursuant to Section 1111(b) of the Code. However, Walter testified credibly that he had studied the financial data relevant to the debtor's property, that his letter of intent reflected terms that were consistent with the terms under which GE Capital made loans on central business district office buildings, and that the all-in rate of return under the terms of the letter of intent would adequately compensate GE Capital. Furthermore, he identified a number of other lenders who he believed would be interested in financing the debtor on similar terms.

The bank attempted to discredit Walter's testimony by characterizing GE Capital as an insignificant market participant. However, as a lender to single asset real estate projects in an annual amount of approximately $2 billion, GE Capital is significant, and has expertise bearing precisely on the issues relevant to a market rate of return on the note proposed by the September 11 plan. As further grounds for disregarding Walter's testimony, the bank's expert referred to a number of funds investing in distressed mortgages, which required returns in the range of 15-25%. Yet it is plain from the analysis set out above that these rates of return must be on properties whose cash flow is subject to much greater risk

---

[3] The Debtor's Supplemental Post-Trial Memorandum, filed November 3, 1995, points out (at 8-10) errors in the bank's expert's calculations that account for the difference in the calculations.

than those of the debtor's property—*i.e.*, properties valued with discount rates much greater than the 12% applicable here. A property generating cash flow at an average of 12% simply cannot support financing at rates of 15-25%.

Accepting the testimony of Robert Walter, the court finds that the compensation to the bank proposed by the September 11 plan provides a market rate of return on the bank's secured claim, and that the treatment of the claim satisfies the requirements of Section 1129(b)(2)(A).[4]

B. Treatment of the bank's unsecured claims.

In addition to its secured claim, discussed above, the bank has unsecured claims in two classes defined by the September 11 plan. First, the bank has an unsecured deficiency claim of $38,469,112, the difference between its total mortgage claim, and the value of its interest in the

---

[4] The one respect in which the debtor's plan is more favorable to the debtor than are the terms of the letter of intent is in the commitment fee. The letter of intent calls for a flat 1% fee of the loan amount, *i.e.*, $533,950. The debtor's plan calls for a commitment fee of $266,975, or such greater amount as the court may determine, up to $545,000 (1% of the total value of the bank's secured claim). The reason given by the debtor for paying the bank a smaller commitment fee than that required by the letter of intent is that GE Capital would need to engage in extensive due diligence in the course of committing to make the loan, while the bank, given its position as a present lender to the property and its involvement in the pending bankruptcy, would not need to incur such expenses in connection with the plan. This observation appears well founded. Moreover, as noted above, even with the reduced commitment fee, the plan provides a substantially greater return to the bank than the terms of the letter of intent would provide to GE Capital. Accordingly, the court will not set a commitment fee higher than $266,975.

debtor's property, pursuant to Section 506(a) of the Code. Second, the bank has purchased general trade claims worth about $5,000, and voted these claims against the debtor's plan. The bank has asserted objections to confirmation based on the proposed treatment of both of these classes of unsecured claims.

Objection 2: Section 1129(a)(7)(A)—the best interests test.

Section 1129(a)(7)(A) of the Code enunciates what was, under the former Bankruptcy Act, the "best interests of creditors" test. See 5 Collier on Bankruptcy ¶ 1129.02[7][a] (15th ed. 1995) for a discussion of the derivation of Section 1129(a)(7). The test provides that if a claim is impaired by a plan of reorganization, and if the holder of the claim has not accepted the plan, then the holder of the claim must receive on account of the claim "property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive . . . if the debtor were liquidated under chapter 7 . . . on such date." Both the bank's unsecured deficiency claim and its trade claims are impaired under the September 11 plan, as discussed later in this opinion, and the bank, as holder, has not accepted the plan. Therefore the plan must provide the bank with payments on its claims having a present value, as of the effective date of the plan, at least equal to the amount that the bank would receive on its claims if the debtor were liquidated in a Chapter 7 case on the plan's effective date.

There is no question that the plan's treatment of the bank's unsecured deficiency claim meets this test. In a Chapter 7 liquidation, the bank would receive nothing on account of this claim. The bank's note is nonrecourse, requiring it to look only to its collateral for payment. Thus, any claim for the deficiency, in Chapter 7, would be disallowed as unenforceable under applicable nonbankruptcy law, pursuant to Section 502(b)(1). The deficiency is an

allowed claim in Chapter 11 only by operation of Section 1111(b)(1)(A). *In re Woodbrook Assocs.*, 19 F.3d 312, 318 (7th Cir. 1994). No payment of the deficiency claim, then, is necessary to meet the best interests test.

The situation is different with respect to the trade debt. The bank contends that these claims would be paid in full, with interest, in a Chapter 7 liquidation, and thus that the treatment of these claims under the plan—payment in full without interest, 180 days after the effective date of the plan—violates the best interests test. In response, the debtor argues that, in a Chapter 7 liquidation, there would only be payment of the principal amount of the claims, and that it would take at least 180 days for that payment to be made. Each of these arguments fails to apply Section 1129(a)(7) properly to the facts of this case.

First, the bank is mistaken in asserting that interest would be paid on trade debt in a Chapter 7 liquidation of the debtor. The debtor here has only two significant tangible assets: its real property, and a $3.1 million cash account. If the debtor were liquidated in a Chapter 7 case, the following events would transpire:

(1) The trustee would abandon the real property pursuant to Section 554 because it is fully encumbered, and its operation would be burdensome. In no event would the estate realize any value from the real estate.

(2) The $3.1 million cash account would be subject to distribution in payment of unsecured claims, pursuant to Section 726(a) of the Code, but it would be insufficient to pay these claims in full. The general unsecured claims against the estate include not only $160,000 in trade debt, but also $7.7 million in unsecured loans from insiders. Under Section 726, unsecured claims are not subject to different treatment simply because they are held by insiders. *Cf. In re Martin's Point Ltd. Partnership*, 12 B.R. 721, 727 (Bankr.N.D.Ga. 1981)

(allowing insider claims to be classified with other unsecured claims and noting that claims of equity holders are generally treated equally with those of other creditors); *In re Holywell Corp.*, 913 F.2d 873, 880 (11th Cir. 1990) (applying the rule of *Martin's Point* to prohibit separate classification of insider claims); 805 ILCS 210/804(l) (the Illinois enactment of Section 804 of the Revised Uniform Limited Partnership Act, under which claims of partners who are creditors of the partnership are treated equally with the claims of other creditors). Moreover, though the bank has questioned the assertion of the insider loans, it has not filed any objection to these claims, and they are deemed allowed, pursuant to Sections 1111(a) and 502(a). Accordingly, there is no reason to conclude that a Chapter 7 trustee would not treat the $7.7 million insider debt together with the $160,000 trade debt as claims to be paid under Section 726.

(3) Because the assets of the estate would be insufficient to pay the unsecured claims in full, a Chapter 7 trustee would pursue the assets of the general partner to the extent of the deficiency, pursuant to Section 723(a) of the Code. However, the Code distinguishes between the payment of claims and the payment of interest on claims. *Compare* 11 U.S.C. § 726(a)(l)-(4) (providing for "payment of claims") *with* 11 U.S.C. § 726(a)(5) (providing for "payment of interest . . . on any claim paid under paragraph (1), (2), (3), or (4) of this subsection"). Section 723(a) affords the trustee a claim against the general partner only to the extent necessary to pay the claims, not to the extent necessary to pay interest on claims. Of the $7.7 million in insider claims, the general partner's claim is $6.8 million. Of this amount, the trustee would likely be able to offset a sufficient amount to allow payment in full of the principal amount of other unsecured claims.

(4) The estate would then be closed with payment in full of all claims but that of the general partner, and partial payment to the general partner.

(5) Because all claims against the estate would not be paid in full, there would be no payment of interest on any unsecured claim, since payment of interest is made under Section 726(a)(5) only after payment of all allowed unsecured claims. The bank's assertion to the contrary is incorrect.

The debtor's mistake in the application of Section 1129(a)(7) is in asserting that payment of liquidation value may be delayed until the payment would likely be made in a Chapter 7 case. To the contrary, Section 1129(a)(7) directs that value be determined as if the debtor were "liquidated" on the effective date of the plan. Although "liquidate" is not defined in the Code, its ordinary meaning, in a financial context, is "[t]o pay off or settle (a debt, claim or obligation)" or "[t]o settle the affairs of (a business firm, for example) by determining the liabilities and applying the assets to their discharge," or, at the very least, "[t]o convert (assets) into cash." The American Heritage Dictionary 735 (2d College ed. 1982). The effect, then, of specifying that a liquidation value be assessed as of the effective date of the plan is to make certain that the creditors be given, as of that date, the value that they would have at the conclusion of the Chapter 7 process. And so, by delaying payment in full of the trade creditors claims for 180 days, the debtor's plan does violate the best interests test.

However, this is not a particularly significant violation. It appears that the debtor has ample cash available to pay all of the trade debt on the effective date of the plan. If the debtor nevertheless wishes to delay payment until after the effective date (perhaps to consider claim objections), it would have to pay interest to the trade creditors for the period of the delay. But since there is no substantial risk that the payment will not be made (the debtor having cash on deposit well in

excess of the amount owed, and the delay in payment being brief), interest at a comparable Treasury rate would be sufficient. The interest required for a 180 day delay in paying the $90,000 in trade debt not held by insiders of the debtor would be no more than $3000. The court will therefore allow confirmation of the September 11 plan, over the bank's "best interests" objection, but only if the debtor modifies the plan, pursuant to Section 1127(a), so as to comply with Section 1129(a)(7). *Cf. Travelers Ins. Co. v. KCC-Leawood Corporate Manor I*, 908 F.2d 343 (8th Cir. 1990) (dismissing appeal from conditional confirmation order).

Objection 3: Section 1129(b)(1)—unfair discrimination.

The best interests test applies to individual creditors holding impaired claims, even if the class as a whole votes to accept the plan. The bank's next objection—that the plan unfairly discriminates—is different. The prohibition against unfair discrimination applies only when a debtor seeks to confirm a plan despite the failure of an entire class to accept the plan. Section 1129(b)(1) provides that the plan may be confirmed against the nonaccepting impaired class (*i.e.*, "crammed down"), only if "the plan does not discriminate unfairly . . . with respect to each class of claims . . . that is impaired under, and has not accepted, the plan." As required by *In re Woodbrook Associates*, 19 F.3d 312, 319 (7th Cir. 1994), the debtor placed the deficiency claim of the bank in a class separate from the other general unsecured claims. The deficiency claim is impaired, and the bank did not accept the plan. Therefore, the deficiency claim may not be subject to unfair discrimination.

Unquestionably, the September 11 plan discriminates between the deficiency claim and the trade debt. As noted above, the trade debt is to be paid in full, shortly after confirmation; the deficiency claim is to be paid only upon

sale or refinancing of the property, and only from half the net proceeds (the other half going to pay participation interest on the bank's secured claim). If the sale or refinancing takes place in 10 years, at the value found by the court, the deficiency claim would be paid about $19 million, half of the claim. If this payment is discounted at the same 12% rate used to value the building, the dividend on the claim is only about 16%. The question is whether this discrimination (full payment of trade debt versus 16% payment of the unsecured deficiency) is unfair.

Answering this question is made difficult by the lack of any clear standard for determining the fairness of a discrimination in the treatment of classes under a Chapter 11 plan. Given the language of Section 1129(b)(1), some discrimination between classes of unsecured claims must be permissible. *In re Aztec Co.*, 107 B.R. 585, 588-89 (Bankr.M.D.Tenn. 1989) (rejecting decisions holding that "all unsecured claimholders must be paid the same percentage of claims" because "Section 1129(b)(1) prohibits only 'unfair' discrimination, not all discrimination."). However, the limits of fairness in this context have not been established. The debtor originally suggested that the court apply a four-part test that was developed in applying Section 1322(b)(1), a parallel prohibition of "unfair discrimination" for Chapter 13 plans. However, that test is unworkable, for the reasons set forth in *In re Brown*, 152 B.R. 232, 235-37 (Bankr.N.D.Ill.), *rev'd on other grounds, sub nom. McCullough v. Brown*, 162 B.R. 506 (N.D.Ill. 1993). At the same time, the alternative test applied in *Brown*, 152 B.R. at 237-39, was specifically grounded in the context and the legislative history of Chapter 13, and has no application to Chapter 11. The Seventh Circuit, in finding that the plan in *In re Woodbrook Associates*, 19 F.3d 312, 317-320 (7th Cir. 1994), involved unfair discrimination, stated only that the plan provided a 5% distribution to the unsecured deficiency claim of a mortgagee

while paying insiders of the debtor in full. The court did not discuss its general understanding of unfair discrimination.

Nevertheless, it is possible at least to lay a framework for measuring the fairness of a discrimination in Chapter 11 plans. First, any discrimination must be supported by a legally acceptable rationale. The result in *Woodbrook* can be seen as flowing from the failure of the debtor, as plan proponent, to give any rationale for discriminating against the mortgagee's deficiency claim and in favor of insiders. In contrast, the court in *In re Creekstone Apartments Associates, L.P.*, 168 B.R. 639, 644 (Bankr.M.D.Tenn. 1994), found that "[p]rotection of the debtor's creditor-worthiness with its vendors," as asserted by the debtor, was an acceptable rationale for discrimination in favor of trade creditors. Second, the extent of the discrimination must be necessary in light of the rationale. Again, the extreme disproportionality between the payments to insiders and to the deficiency claim of the mortgagee contributed to the finding of unfair discrimination in *Woodbrook,* and a similar disproportionality contributed to a finding of unfair discrimination in *In re Creekside Landing,* 140 B.R. 713, 716 (Bankr.M.D.Tenn. 1992).

Within this framework, the debtor's plan does not unfairly discriminate. First, the debtor has provided a compelling rationale for the discrimination in its treatment of unsecured claims: the best interests test. As discussed above, this test, set forth in Section 1129(a)(7) of the Code, requires that the debtor pay holders of impaired claims as much as they would have received in a Chapter 7 liquidation, and, in a Chapter 7 liquidation, the trade creditors in the present case would be paid in full. Thus, full payment of these claims under the debtor's plan was required for confirmation. On the other hand, the deficiency claim would be paid nothing in a Chapter 7 case, and so the best interests test does not mandate payment of this claim at any particular level. Since

the debtor does not now have sufficient funds to pay all of its creditors in full, and is unlikely to have sufficient funds during the course of its plan, some creditors—other than holders of trade debt—must be paid less than 100% of their claims.

Second, the discrimination in the debtor's plan is narrowly tailored to meet the requirements of the best interests test: the trade creditors are paid no more than the face amount of their claims, and all insider claims are either waived or subordinated to the bank's deficiency claim, allowing that claim to be paid in full before insiders of the debtor receive any payment under the plan. It is not clear that this degree of deference to the bank's deficiency claim would be required; valid insider claims may well have been paid on a par with the deficiency claim without unfair discrimination. However, the discrimination in the present plan, which, far from favoring insiders, subordinates them, cannot be seen as unfair to the deficiency claim.

Objection 4: Section 1129(b)(2)(B)—absolute priority and new value.

Just as Section 1129(b)(2)(A) sets forth minimum standards for applying the "fair and equitable" standard to secured claims in cram down, Section 1129(b)(2)(B) sets forth the minimum standards for "fair and equitable" treatment of unsecured claims. This minimum standard is the "absolute priority rule": unless each claim in a nonaccepting class of unsecured claims is paid in full (*i.e.*, given "property of a value, as of the effective date of the plan, equal to the allowed amount of such claim"), the plan must provide that "the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property." 11 U.S.C. § 1129(b)(2)(B).

The bank argues that this provision is violated with respect to its deficiency claim. This claim, as noted above, will not be provided full payment under the debtor's plan. Nevertheless, holders of partnership interests in the debtor—which, as equity, are junior to the bank's claim—do receive property under the plan: retention of their ownership of the debtor, with the right to participate in the proceeds of any sale or refinancing of the property (albeit subordinated to the deficiency claim). The question is whether this retention of ownership is "on account of" the interests that the partners had at the outset of the case, or whether the retention of ownership is on account of the new capital contributions that the plan requires partners to make. A further question is whether, even if the new contributions are seen as the cause for the debtor's partners continuing to have partnership interests, the right to retain these interests in exchange for the new contributions is itself property that the partners receive on account of their prepetition interests.

These "new value" questions have been discussed in a large number of sharply divided opinions and commentary. The United States Supreme Court issued an opinion noting the question whether contributions of new value can ever support retention of ownership interests where creditors of the estate receive less than full payment, but expressly leaving the question open, and holding only that if new value can have this effect, it must be in the form of money or money's worth, rather than a promise to provide labor to the debtor. *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 203 n.3 (1988). The Seventh Circuit likewise has raised the question several times, but declined to rule on it. One opinion of the court, *Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1359-62 (7th Cir. 1990), presents a number of arguments against allowing retention of ownership through contribution of new value, but the opinion declines to reach the question, holding instead that the guarantees proposed to

be contributed by the debtor's owners would be insufficient in any event. Another decision of the court, *In re Snyder*, 967 F.2d 1126, 1128-31 (7th Cir. 1992), presents arguments in favor of allowing retention of ownership based on contribution of new value, but again declines to reach the question, holding that the bankruptcy court had not committed error in finding the $30,000 contribution proposed in that case to be insufficiently "substantial." Among decisions from other jurisdictions that actually do reach the issue, *In re A.V.B.I.*, 143 B.R. 738 (Bankr.C.D.Cal. 1992), thoroughly presents the arguments against allowing retention of ownership based on contribution of new value, and *In re Bonner Mall Partnership*, 2 F.3d 899 (9th Cir. 1993), thoroughly presents the contrary view.

This court is persuaded by the arguments advanced in *Bonner Mall* and *Snyder*, and will only summarize them here very briefly. The salient points are: (1) the language of Section 1129(b)(2)(B) cannot unambiguously be applied in the context of a contribution of new value by the debtor's owners; (2) given this genuine ambiguity, it is appropriate to look at pre-Code practice for aid in interpretation; (3) prior to the adoption of the Code, and particularly after *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 121 (1939), the availability of the "new value" approach to reorganization was generally recognized; (4) nothing in the legislative history of the Code, or the language of the Code itself, gives any clear indication that Congress intended to eliminate the new value approach. Accordingly, Section 1129(b)(2)(B) should be interpreted to allow retention of ownership interest "on account of" a contribution of new value, consistent with the requirements that the courts have imposed on this approach.

In *Snyder*, the court applied in effect a four-factor test for retention of ownership on account of a new value contribution. Citing *Los Angeles Lumber*, 308 U.S. at 121-

122, the court stated: "[A] qualifying new value contribution must be (1) necessary to the reorganization; (2) in the form of money or money's worth; and (3) reasonably equivalent to the interest retained." *Snyder*, 967 F.2d at 1131. The court added a fourth factor, that the contribution be "substantial," based on decisions rendered subsequent to *Los Angeles Lumber*. *Id.* Later, in *In re Woodbrook Associates*, 19 F.3d 312, 320 (7th Cir. 1994), the court commented further on the substantiality requirement, implying that substantiality serves as something of a summary of the other factors:

> Simply put, "substantiality" requires that the contribution be real and necessary to the successful implementation of a feasible plan. . . . A token cash infusion violates the absolute priority rule because the old equity owners are receiving the opportunity to purchase the new equity interest at a bargain price "on account of" their prepetition ownership.
>
> Whether the infusion of new capital is "substantial" is more a common sense determination than a mathematical calculation when the debtor comprises only a single real estate asset which is fully encumbered.

The three *Los Angeles Lumber* factors are satisfied by the new value proposed to be contributed under the debtor's September 11 plan. First, the contribution is necessary to the reorganization. The contribution was an essential ingredient in allowing a market rate of return to the bank's secured claim. Although the bank argues that the plan still will not succeed, the contribution is necessary for any attempt at reorganization. Second, the contribution is at least partly in the form of money or money's worth: cash and promissory notes secured by a letter of credit, with a present value of $4.1 million as of plan confirmation. The parties dispute whether the last three scheduled contributions should be

counted as "money's worth," but that dispute is not material here.[5] Third, the contribution is easily the equivalent of the interests retained by the debtor's partners. Indeed, on the market, those interests are worthless. Even after ten years of successful operation of the property under the September 11 plan, the entire proceeds of a sale or refinancing are projected to go to the bank. The debtor's partners thus seek to retain their interests not because of the intrinsic value of these interests, but because of the tax consequences that flow from their loss.

Rather than the three *Los Angeles Lumber* factors, it is the fourth new value factor—substantiality—that is principally in dispute here. The bank argues that the $4.1 million present value of the presently assured contributions should be compared to the total amount of unsecured debt, $58 million, making the contribution about 7% of the unsecured debt. The bank then points to decisions in which proposed new value contributions of between 2 and 6% of unsecured claims were found to be insubstantial. (In *Snyder*, the proposed contribution was 2.7% of total unsecured claims, 967 F.2d at 1131; in *Woodbrook*, the ratio was "at most" 3.8%, 19 F.3d at 320). The bank's argument is misguided in two respects. First, the total unsecured claims are not relevant here, since many of these claims belong to the general partner or an entity that it controls, and these insider claims have either been waived or subordinated to the bank. Similarly, the noninsider trade debt is paid in full under the plan. Thus, the only unsecured claim that is being involuntarily "primed" by the partners' retention of equity is the deficiency claim of the bank, in the amount of $38,469,112. The proposed new value contribution is about 10.7% of this amount. Second,

---

[5] Similarly, it is not necessary to determine whether the waiver by the general partner of $6.9 million in general unsecured claims constitutes money's worth.

and more significantly, percentage comparisons of contribution value to unsecured claims are not dispositive. In *Snyder*, the Seventh Circuit cautioned that "there is no mathematical formula for resolving the substantiality issue, and it will depend on the circumstances of the individual case." 967 F.2d at 1131-32. And in both *Woodbrook* and *Snyder*, the court emphasized that the determination of substantiality "may not always hinge on a comparison of the proposed contribution to the total amount of unsecured debt." Here, the new value being contributed by the partners is substantial both in absolute terms and in its impact in this case. The $4.1 million minimum value of the contribution in this case dwarfs the $30,000 involved in *Snyder* and the $100,000 in *Woodbrook*. It constitutes over 20% of the tax liability the partners hope to avoid. And, most significantly, the total contribution package, however valued, is substantial enough to make possible a commercial loan on the debtor's property consistent with the terms of the proposed plan. That plan, in turn offers a substantial (16%) return on the bank's deficiency claim. The new value contributions proposed by the September 11 plan are not mere tokens, but genuine contributions to the proposed plan.

In all, the plan treats the unsecured claims held by the bank, both trade claims and the unsecured deficiency claim in a manner consistent with the requirements of Section 1129.

C. General requirements for confirmation.

In addition to specifying minimum standards for the treatment of claims, Section 1129 sets forth a number of general requirements for confirmation. The bank asserts that the debtor has failed to establish compliance with several of these general requirements.

Objection 5: Sections 1129(a)(1), 1123(b)(6), 365(c)(2)—forced relending.

At the outset of the hearing on confirmation of the September 11 plan, the plan contained a provision requiring the bank to relend to the debtor, at the debtor's request, any payments made by the debtor in excess of scheduled amortization, to the extent these funds were reasonably needed for alterations to the property, tenant improvements, and leasing commissions. The plan also had a provision for judicial resolution of disputes in the event the bank objected to any request by the debtor for such relending. After the bank objected to these provisions during the hearing, the debtor submitted a modified plan, omitting them. The plan, as currently proposed, specifies only (1) that the debtor may request relending, (2) that if the bank fails to respond within 10 business days after receipt of the request, the bank will be deemed to have agreed to it, and (3) that if the bank refuses the request, the bank must set forth its grounds for so doing. The plan now explicitly provides that the Bank has sole discretion regarding the granting of the request, and the procedure for court resolution of a dispute between the parties on this issue has been eliminated.

Nevertheless, the bank contends that the relending provisions violate Section 365(c)(2) of the Code, which provides that a trustee (and hence a debtor in possession, pursuant to Section 1107(a)) may not "assume or assign any executory contract . . . if . . . such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor." Of course, even as originally drafted, the September 11 plan did not purport to assume any existing loan agreement with the bank. It sought to create a new obligation on the part of the bank to extend a kind of revolving credit line. Hence, Section 365(c)(2) does not apply by its terms. Rather, the bank argues that the spirit of Section 365(c)(2) is to prevent

creditors from being required to lend money involuntarily to debtors. Then, because Section 1123(b)(6) only allows a plan to include provisions "not inconsistent with the applicable provisions" of the Code, the bank contends that the debtor has exceeded its authority under Section 1123. Ultimately, such an improper provision in a plan would violate Section 1129(a)(1), which requires that a plan comply with the applicable provisions of the Code.

It is not necessary here to analyze all the steps of the bank's argument, since the argument is flawed at its premise. The September 11 plan imposes no obligation on the bank to make any loan. The only obligation imposed is to make a reasonably prompt response to a loan request, with a specification of reasons for a denial. Clearly, the debtor still hopes to establish a revolving loan arrangement with the bank, and the plan sets up the mechanism for such an arrangement. However, in the event the bank chooses not to accept this arrangement, it is given sole discretion to reject it. In this way, the debtor's revised plan tracks the terms of the letter of intent with GE Capital. That letter, like the current plan, created the structure for a revolving loan arrangement based on excess amortization payments, but gave the lender sole discretion in extending financing under that structure.

Creating this structure is not inconsistent with the Bankruptcy Code. Under Section 1123(b)(6), a debtor is affirmatively authorized to include in a plan general provisions that are not inconsistent with other provisions of the Code. *See In re Trans World Airlines, Inc.*, 185 B.R. 302, 313 (Bankr. E.D.Mo. 1995) (confirming a plan containing numerous provisions pursuant to Section 1123(b)(6)). No provision of the Code is inconsistent with a plan requiring that the debtor's principal secured creditor respond with reasonable promptness and specificity to a request from the debtor for financing. Indeed, such a requirement is quite sensible: a prompt response from the

bank to a request by the debtor for financing from excess amortization will give the debtor the opportunity to correct any problems with its request if the bank is willing to consider the financing requested, or to make alternative arrangements if the bank will not consider the financing.

Objection 6: Section 1129(a)(3)—good faith.

Section 1129(a)(3) of the Code requires that any Chapter 11 plan be proposed in good faith. The bank argues that the debtor's motivation for filing its plan—avoidance of adverse tax consequences—in itself establishes that the plan was proposed in bad faith, particularly in the context of a single asset real estate case.

This argument is not consistent with governing law. First, the fact that this is a single asset real estate case does not render it a bad faith filing. The Bankruptcy Code contains no provision to this effect, and, to the contrary, was recently amended to deal specifically with certain single asset real estate cases. See 11 U.S.C. §§ 101(51B) (defining "single asset real estate") and 362(d)(3) (providing special grounds for relief from the automatic stay in single asset real estate cases), each added to the Code by Section 218 of the Bankruptcy Reform Act of 1994. *See also In re James Wilson Assocs.*, 965 F.2d 160 (7th Cir. 1992) (affirming confirmation of Chapter 11 plan in single asset real estate case). The Supreme Court itself has rejected the notion that Chapter 11 is limited to a particular type of business reorganization in holding that individuals are eligible for Chapter 11 relief. *Toibb v. Radloff*, 501 U.S. 157, 161 (1991).

Second, the bank's focus on the debtor's intent in filing the case is inappropriate. In *In re Madison Hotel Associates*, 749 F.2d 410, 425 (7th Cir. 1984), the court interpreted Section 1129(a)(3) as focusing on the content and effect of the

plan under consideration, not the subjective motivation of the plan proponent:

> [F]or purposes of determining good faith under section 1129(a)(3) . . . the important point of inquiry is the plan itself and whether such plan will fairly achieve a result consistent with the objectives and purposes of the Bankruptcy Code.

Accord, In re Andreuccetti, 975 F.2d 413, 420 (7th Cir. 1992). The evidence presented at the confirmation hearing is consistent with this standard of good faith. The debtor has proposed a plan which sets forth an effort to pay noninsider claims (including the bank's deficiency claim) as much or more than they would receive in a liquidation. It delays any payment of insider claims until the sale or refinancing of the property, and then makes that payment subordinate to the bank's deficiency claim. It provides significant protection to the bank's secured claim. Its discrimination among unsecured claims, as discussed above, is reasonable. In proposing the terms of its plan, the debtor was admittedly motivated by fear of adverse tax consequences in the event a plan were not confirmed, but this has no effect on the operation of the plan.

Finally, even if the bank's challenge were considered as a request for relief based on bad faith in the debtor's *filing* of the case, an issue not particularly relevant to confirmation, the motivation of avoiding adverse tax consequences would still fail as evidence of bad faith. *In re Cadwell's Corners Partnership*, 174 B.R. 744, 762 (Bankr.N.D.Ill. 1994). Few bankruptcies, likely, are filed with altruistic intent; every debtor presumably files to obtain some benefit for itself or avoid some harm. *In re James Wilson Assocs.*, 965 F.2d 160, 170 (7th Cir. 1992) ("It is not bad faith to seek to gain an advantage from declaring bankruptcy—why else would one declare it?"). In its most general formulation, the standard for good faith in filing simply requires that, in pursuing its own interests, the debtor act with "fundamental fairness" and

"in a manner that complies with the spirit of the Bankruptcy Code's provisions." *In re Love*, 957 F.2d 1350, 1357 (7th Cir. 1992). Thus, unnecessary bankruptcies filed by debtors who can pay their creditors in the ordinary course, useless bankruptcies filed without prospect for reorganization, and harassing bankruptcies filed as part of a pattern of delay or misconduct, are found to be filed in bad faith. *In re N.R. Guaranteed Retirement, Inc.*, 112 B.R. 263 (Bankr.N.D.Ill.), *aff'd* 119 B.R. 149 (N.D.Ill. 1990) (discussing specific circumstances leading to findings of bad faith filing).

In the present case, none of these circumstances exist. At the time of the filing of this case, the debtor was genuinely in need of bankruptcy relief, with an expired mortgage and a pending foreclosure action. At the same time, given the quality and substantial cash flow of the debtor's property, there was a genuine prospect for reorganization, as reflected in this opinion. And there has been no pattern of delay here: the bankruptcy case was filed shortly after the mortgage became due, and it has proceeded expeditiously, with the debtor meeting all court-imposed deadlines.

Objection 7: Section 1129(a)(5)—quality of management.

Section 1129(a)(5) of the Code imposes, as a requirement for confirmation, (1) that there be disclosure of any individual proposed to serve, after confirmation, "as a director, officer, or voting trustee of the debtor," and (2) that the holding of office by each such individual "is consistent with the interests of creditors and equity security holders and with public policy." The bank asserts that this provision has not been complied with in the present case, because the debtor's management, prior to the bankruptcy filing and contrary to its agreement with the bank, made a deposit of rents that would otherwise have been used to pay real estate taxes into an account at another bank. The bank contends that the nonpayment of real estate taxes constitutes waste under

Illinois law, and that a willingness to engage in such nonpayment makes the continuation of current management contrary to the interests of creditors. The bank also asserts that changes in management personnel since the filing of this case further call into question the quality of the debtor's management. In support of its arguments, the bank cites *In re Rusty Jones, Inc.*, 110 B.R. 362, 375 (Bankr. N.D.Ill. 1990), and *In re SM 104 Ltd.*, 160 B.R. 202, 245 (Bankr.S.D.Fla. 1993).

The cited cases, however, presented factual situations very different from the present one. In each, the debtor's management had engaged in a pattern of conduct detrimental to creditors, including, in the *SM 104* case, deliberate violations of court orders and potentially fraudulent misrepresentations. Thus, *Rusty Jones* and *SM104* are consistent with the apparent intent of Section 1129(a)(5) to preclude continued service by prior management "if it directly or indirectly perpetuates incompetence, lack of discretion, inexperience, or affiliations with groups inimical to the best interests of the debtor." *In re Polytherm Indus., Inc.*, 33 B.R. 823, 829 (W.D.Wisc. 1983). Here, the bank points to a single transfer, which involved no conversion, but simply retained funds in the control of the debtor, and which was disclosed in the debtor's schedules. The transfer was an error in judgment—it exposed the debtor to tax penalties unnecessarily, and it was unlikely to achieve its intended purpose of advancing settlement discussions with the bank. However, the transfer is not indicative of a general course of conduct prejudicial to creditors. Moreover, the representative of the debtor who authorized the transfer testified without contradiction to extensive experience in managing commercial real estate successfully. *Cf. In re Landing Assocs., Ltd.*, 157 B.R. 791, 817 (Bankr.W.D.Tex. 1993) (confirming Chapter 11 plan over objection to continued management "in light of

the vast experience" of the individuals employed by the debtor in managing real estate).[6]

Finally, the fact that the on site personnel employed by the debtor's management decided to accept new employment pending confirmation of this case is hardly evidence that the management company is incompetent. Given the uncertainty of the outcome of the case, and the potential for foreclosure followed by loss of employment, it is understandable that the onsite personnel would take the action that they did. However, with plan confirmation, there is no reason to doubt that debtor's management will be able to hire competent replacements.

Objection 8: Section 1129(a)(10)—acceptance by an impaired class.

Whenever a Chapter 11 plan impairs a class of claims, another requirement for confirmation is that "at least one class of claims that is impaired under the plan has accepted the plan." 11 U.S.C. § 1129(a)(10). The debtor seeks to satisfy this requirement by pointing to the affirmative vote of a class of general unsecured creditors.[7] However, the bank

---

[6] The bank also argues that Section 1129(a)(5) is violated because the management firm employed by the debtor is paid a management fee of 4% instead of the 3% rate that the bank believes is appropriate. However, Section 1129(a)(5)(B) provides only that the identity and compensation of insiders to be employed by the debtor be disclosed, not that it be approved by the court. *In re All Seasons Indus., Inc.*, 121 B.R. 822, 826 (Bankr.N.D.Ind. 1990). In any event, the evidence presented at the confirmation hearing indicates that the 4% rate is not unreasonable.

[7] If the bank's deficiency claim had been included in this class, its vote against confirmation would have resulted in the class not accepting the plan. However, as noted above, the bank's

(continued...)

argues that this class's vote does not satisfy the requirement of Section 1129(a)(10) because the class was "artificially" impaired.

As the term relates to Chapter 11 plans, "impairment" is defined by Section 1124 of the Code. This section provides, with an exception not relevant here, that every class of claims is impaired, "unless, with respect to each claim . . . of such class" the plan either (1) "leaves unaltered the legal, equitable, and contractual rights to which such claim or interest entitles the holder of such claim or interest" or (2) reverses the acceleration of an indebtedness caused by default, through a defined cure process, and otherwise leaves the rights of the holder of the claim unaltered. Until recently, Section 1124 contained a third ground for finding a claim unimpaired: that "on the effective date of the plan, the holder of such claim . . . receives, on account of such claim . . . cash equal to . . . the allowed amount of such claim." This third ground might have applied to debtor's plan, depending on how the plan was modified to comply with the best interests test. However, the third ground of nonimpairment was deleted by Section 213(d) of the Bankruptcy Reform Act of 1994, Pub. L. 103-394, effective as to cases filed on or after October 22, 1994.

Under current law, the debtor's plan plainly does impair the class of general unsecured claims. The creditors holding these claims are, at the very least, delayed in the right to payment that existed under their agreements with the debtor, and they are not provided interest to which they would

---

[7] (...continued)
deficiency claim was placed in a separate class, as required by *In re Woodbrook Assocs.*, 19 F.3d 312, 317-320 (7th Cir. 1994) (separate classification of the deficiency claim of a nonrecourse secured creditor is not only permitted, but required, in light of the unique legal status of such a claim).

otherwise be entitled.[8] However, the bank contends that this impairment is "artificial" and hence should not be recognized, because the debtor had the ability to pay the unsecured creditors, in full, with interest, at the time of the confirmation hearing.

The leading case for denying confirmation on the ground of artificial impairment is *In re Windsor on the River Associates*, 7 F.3d 127 (8th Cir. 1993). *Windsor* was a single asset real estate case in which the secured creditor's claim was oversecured by the debtor's property, and in which the debtor's plan provided that a class of trade creditors would be paid 60 days after the effective date of the plan. The delay in payment effected an impairment under Section 1124, but the Eighth Circuit refused to recognize this impairment. The court held that, "for purposes of 11 U.S.C. § 1129(a)(10), a claim is not impaired if the alteration of rights in question arises solely from the debtor's exercise of discretion." 7 F.3d at 132. Then, because it would have been possible for the debtor to have structured the plan so as to pay the trade debt in full on the effective date, leaving the secured creditor as the only impaired creditor, the court found that an "arbitrary manipulation" of claims had taken place. 7 F.3d at 132-33.

Windsor thus requires the denial of confirmation in any case where it would be possible to structure a plan without an approving impaired class. This rule has been rejected by the

---

[8] Under Illinois law, even in the absence of a contractual provision, interest is payable on liquidated debts. 815 ILCS 205/2 (1994); *Premier Elec. Const. Co. v. American Nat. Bank*, 656 N.E.2d 157, 167 (Ill.App. 1995) ("Under Illinois law, absent an express contract provision allowing interest at a specific rate, a party is only entitled to prejudgment interest at the statutory rate from the date payment is due to the date of entry of the judgment.")

Ninth Circuit Bankruptcy Appellate Panel as unsupported by the language of the Code, and as inconsistent with the Code's policy of flexibility in plan formulation. *In re Hotel Assocs. of Tucson*, 165 B.R. 470, 475 (Bankr.9th Cir. 1994); *accord, In re Beare Co.*, 177 B.R. 886 (Bankr.W.D.Tenn. 1994). And even courts that find *Windsor's* rationale persuasive have not applied its rule that impairment under Section 1129(a)(10) must be unavoidable. Rather, these cases have found artificial impairment only where there is no reason for the impairment other than obtaining compliance with Section 1129(a)(10). *In re Investors Florida Aggressive Growth Fund, Ltd.*, 168 B.R. 760, 766 (Bankr.N.D. Fla. 1994) (denying confirmation where compliance with Section 1129(a)(10) was "the only purpose for the impairment of a class"); *In re North Washington Center Ltd. Partnership*, 165 B.R. 805, 810 (Bankr.D.Md. 1994) (denying confirmation where the debtor had "absolutely no reason" for impairing the only accepting class of creditors). Consistent with this view of artificial impairment, the court in *In re Rivers End Apartments, Ltd.*, 167 B.R. 470, 479 (Bankr.S.D.Ohio 1994), confirmed a Chapter 11 plan over an artificial impairment objection because the debtor made a showing that impairment of unsecured claims (by delay in payment) was desirable for business purposes—even though it was not essential—leading the court to find that the delay was "not proposed solely to achieve impairment."

Thus, there appears to be a developing consensus among the decisions that the "artificial impairment" objection is best seen, not as a ground for finding noncompliance with Section 1129(a)(10), but as an argument that a plan has not been proposed in good faith, a separate requirement for confirmation under Section 1129(a)(3), discussed above. This consensus is responsive both to the language of the Code and to the concerns reflected in *Windsor*. As the Bankruptcy Appellate Panel suggests in *Hotel Associates of Tucson*, it is

difficult to hold that a class should not be counted as "impaired," when, by the definition of Section 1124, it plainly is impaired. 165 B.R. at 474. On the other hand, courts should not be required to accept manipulation of the confirmation process, by debtors carving out classes that are likely to confirm the plan, and then treating those classes in a manner that technically impairs them but provides significant incentives to approve the plan. Where such manipulation occurs, it should result in a denial of confirmation under the good faith requirement. *In re Beare Co.*, 177 B.R. at 889 ("[G]ood faith under § 1129(a)(3) is the real issue to be decided, not impairment.").[9]

In the present case, there is no lack of good faith in the system of classification and payment set forth by the debtor's plan. The debtor's operations are not anticipated to generate sufficient income to pay all unsecured claims in full, with interest. Therefore, the debtor had to impair claims. The debtor addressed this situation in a manner that is highly favorable to the noninsider creditors by providing for payment of the principal of all noninsider claims before any payment of insider claims. Presumably, the debtor could have arranged for payment of the trade debt with interest from the time of filing (thus reducing the funds payable to the bank on its unsecured deficiency claim), but nothing in the Code

---

[9] The debtor argues that the bank lacks standing to make an artificial impairment argument because it is not a member of the allegedly impaired class. Since the real thrust of the artificial impairment argument is a challenge to good faith under Section 1129(a)(3), the bank plainly has standing to make the argument. *See Big Shanty Land Corp. v. Comer Properties, Inc.*, 61 B.R. 272, 280 (N.D.Ga. 1985) (holding that a creditor of estate has standing to raise good faith argument and that the court has an independent duty to examine good faith in any event).

requires such treatment, particularly when it would result in denial of confirmation for lack of an accepting impaired class.

The plan has been accepted by an impaired class, and there is no lack of good faith in the debtor's failure to pay that class interest on its claims.

Objection 9: Section 1129(a)(11)—feasibility.

The final objection made by the bank is that the debtor's plan fails to meet the requirement of Section 1129(a)(11) that "[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization of the debtor . . . unless such liquidation or reorganization is proposed in the plan." This provision is commonly referred to as the "feasibility" test. *See* 5 Collier on Bankruptcy ¶ 1129.02[11] (15th ed. 1995) (discussing the derivation of Section 1129(a)(11)). The language of the subsection clearly establishes its reach: "[T]he feasibility standard is whether the plan offers a reasonable assurance of success. Success need not be guaranteed." *Kane v. Johns-Manville Corp.*, 843 F.2d 636, 649 (2d Cir.), *cert. denied*, 488 U.S. 868 (1988). One recent district court opinion summarized the case law interpreting Section 1129(a)(11) as follows:

> A plan meets this feasibility standard if the plan offers a reasonable prospect of success and is workable. The prospect of financial uncertainty does not defeat plan confirmation on feasibility grounds since a guarantee of the future is not required. The mere potential for failure of the plan is insufficient to disprove feasibility.

In re Patrician St. Joseph Partners Ltd. Partnership, 169 B.R. 669, 674 (D.Ariz. 1994) (citations omitted).

Under this standard, the September 11 plan is plainly feasible. The projected cash flow set out in the court's findings of fact is sufficient to pay all of the debtor's

anticipated expenses, together with required debt service to the bank, for 6 years. Indeed, at the end of that period, the cash flow found by the court will result in "excess" cash flow, in an amount of nearly $7.5 million, paid on the principal of the new note, leaving a loan balance of $43.5 million, even if the debtor's partners fail to make the last three capital contributions required under the plan. See Debtor's Supplemental Post-Trial Memorandum, filed November 3, 1995, Exhibit D. If all of the capital contributions are made, the loan balance would be $41.5 million. *Id.*, Exhibit C. During the seventh year of the plan, due to anticipated expenses in connection with the renewal of the largest tenant's lease, the projected cash flow is not sufficient to make the required debt service. This situation continues in the eighth year of the plan, albeit to a much smaller extent. In the ninth and tenth years of the plan, projected cash flow once again substantially exceeds the amount needed for required debt service.

The bank contends that this situation shows a lack of feasibility, since, as discussed above, the debtor cannot require the bank to relend any of the excess amortization payments at the time of the anticipated shortfalls in cash flow. However, the debtor's inability to force a loan from the bank does not imply failure of the plan. In the situation outlined above, it is likely that the bank will make the loan willingly. The bank would have enjoyed six years of successful operation of the property, and would, at the time of the request for relending, have a debtor with stable income prospects and a defined short term cash flow shortage. Not only would the bank be given a generous return on the short term lending, the ultimate effect of the lending would be to increase the debtor's equity in the property, which equity would inure completely to the bank through participation interest and payment of its unsecured deficiency claim.

Alternatively, the debtor would have the option of selling the property and prepaying the loan without penalty. The experts of each party testified to an improving market for office buildings in the Chicago central business district.

Finally, if the anticipated cash shortfall in the seventh year of the plan cannot be made up by the debtor, there will still be no "liquidation, or the need for further financial reorganization of the debtor." The debtor's plan itself provides for a consensual transfer of the property to the bank in the event of default, and, this feature of the plan is likely to be enforced in any subsequent bankruptcy proceeding.

The debtor has established the feasibility of its plan.

Conclusion

For the reasons set forth above, the court finds that the debtor has established that its September 11 plan complies with all of the applicable requirements of Section 1129 except for Section 1129(a)(7). That deficiency may be remedied either by paying trade creditors in full on the effective date of the plan, or by paying them interest at a comparable treasury rate during the period of any delay in payment. Upon modification of the plan to effect one of these changes, the court will enter an order of confirmation.

Dated: December 5, 1995

/s/ Eugene R. Wedoff
Eugene R. Wedoff
U.S. Bankruptcy Judge